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THE DISCLOSURE OF LONG-TERM LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

by

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies for acceptance, a thesis entitled The Disclosure of Long-Term Leases in the Financial Statements of Lessees, submitted by Dick Johnston in partial fulfilment of the requirements for the degree of Master of Business Administration.

Abstract

The problem considered in this thesis is whether or not long-term leases should be capitalized for balance sheet disclosure at the discounted value of the future rental payments under the lease.

A deductive approach was employed wherein the concepts and definitions of the capitalization method were discussed. It was generally concluded that all long-term, noncancellable leases should be shown in this manner, since the lessee receives the potential services embodied in the asset while incurring a definite obligation to pay for this right, in the same manner as any other financing arrangement.

The empirical evidence, as provided by two mail questionnaires, did not support the complete capitalization of all long-term, noncancellable leases, but did indicate that capitalization would be an acceptable method of disclosing those leases which were in substance purchases of the property. As well, a more complete and consistent application of the disclosure criteria for long-term lease footnotes was requested by the respondents.

The principal recommendation of the study is that those leases which provide, in effect, for the installment purchase of the property should be capitalized at present value of the future lease payments, and disclosed among the fixed assets of the entity. The obligation under the lease should also be disclosed as a long-term liability, together with proper details explaining the nature of the arrangement.

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Table of Contents

List of Tables

Chapter I

INTRODUCTION

Nature of the Problem

The use of long-term leases to acquire fixed assets has prompted extensive discussion and controversy in accounting, especially regarding their proper disclosure in financial statements. The American Institute of Certified Public Accountants has recognized the importance of this problem and has suggested methods of disclosing long-term leases in the financial statements of the lessee. The American Institute of Accountants[1] presented an early pronouncement on accounting for lease transactions in AIA Bulletin No. 38[2], released in 1949.

Bulletin No. 38 was prepared as a result of the increased use of lease financing following World War II. It was essentially an attempt to clarify the AICPA'S position on the proper disclosure of long-term leases in financial statements. The bulletin explained that the long-term lease should be considered a substitute for asset ownership and mortgage borrowing, yet it suggested that neither the asset nor the obligation needed to be reflected on the balance sheet, except when the lease was in substance a purchase of property. The Committee urged footnote disclosure in financial statements for material amounts

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[1]The American Institute of Accountants (AIA) now known as the American Institute of Certified Public Accountants (AICPA).

[2]Committee on Accounting Procedure, American Institute of (Certified Public) Accountants, Accounting Research Bulletin No. 38 (New York: American Institute of (Certified Public) Accountants, 1949).

of future payments under the lease, together with the period in which these rentals were payable. Details of sale and leaseback agreements were required in the year the transaction was consummated.

Capitalization of future lease payments was suggested first in Bulletin No. 38, but was restricted to those contracts which were long-term financing agreements where the lessee was essentially purchasing the asset. The prescribed accounting practice for these leases was:

> ... where it is clearly evident that the transaction involved is in substance a purchase, then the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.[3]

However, little uniformity was evoked by the bulletin, as most companies continued with inadequate and inconsistent accounting methods.[4] Most disclosure was by footnote, which did not fulfill the requirements of those people using financial statements for decision making purposes. As well, the balance sheet disclosure of those leases which were in effect purchases of property had virtually been ignored. The problem was not that disclosure was needed, but that the methods and extent of disclosure had to be established.

Chapter 14 of Accounting Research Bulletin No. 43 "Disclosure of Long-Term Leases in Financial Statements of Lessees" superseded Bulletin No. 38, but did little to change the substance of the earlier bulletin. Bulletin No. 43 stated the problem of accounting for long-term leases:

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[3] Ibid., p. 293.

[4] American Institute of Certified Public Accountants, Accounting Trends and Techniques 1967 (21st ed.; New York: American Institute of Certified Public Accountants, 1967), p. 75.

> Where long-term leases are used as a substitute for ownership and mortgage borrowing, a question arises as to the extent of disclosure to be made in financial statements of the fixed annual amounts payable and other important terms under such leases.[5]

This bulletin recommended many of the same accounting methods as Bulletin No. 38: (1) footnote disclosure of material obligations to be paid under a lease was necessary as well as the periods in which the rental expenditures were expected to be made; (2) property rights and liabilities should be capitalized for those leases which were in substance purchases of property; and (3) full disclosure of the details of sale and leaseback contracts in the year of the transaction.[6]

The Committee had stated its position on the controversial issue of capitalization of long-term leases in these two bulletins and this encouraged many articles, both in favor and against, in subsequent years. Gant, in a comprehensive review, discussed many of the advantages and disadvantages of long-term lease financing.[7] This article has often been quoted as an authority on the nature of lease arrangements. Vancil and Anthony believed that long-term, noncancellable leases were equivalent to debt in theory.[8] They surveyed a number of financial analysts and

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[5] Committee on Accounting Procedures, American Institute of Certified Public Accountants, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43 (New York: American Institute of Certified Public Accountants, 1953), p. 125.

[6] *Ibid.*, p. 126.

[7] Donald R. Gant, "Illusions in Lease Financing," Harvard Business Review (March - April, 1959), pp. 121-42.

[8] Richard F. Vancil and Robert N. Anthony, "The Financial Community Looks at Leasing," Harvard Business Review (November - December, 1959), pp. 113-30.

concluded that this fact was recognized in practice.

As the financial statement reporting of leases become more important, and the methods less consistent, the AICPA commissioned Myers to conduct an accounting research study into the problems of long-term leasing. This was released in 1962, as Accounting Research Study No. 4. Specifically, the study was concerned with the question "... whether assets or liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the lessee."[9] Myers recommended that "to the extent, then, that leases give rise to property rights, those rights and related liabilities should be measured and incorporated in the balance sheet."[10] He also noted that, of the total lease payments, only a specific portion of this obligation should be capitalized.

> To the extent, then, that the rental payments represent a means of financing the acquisition of property rights which the lessee has in his possession and under his control, the transaction constitutes the acquisition of an asset with a related obligation to pay for it. To the extent, however, that the rental payments are for services such as maintenance, insurance, property taxes, heat, light, and elevator service, no asset has been acquired and none should be recorded.[11]

It should be emphasized that Myers advocated the capitalization of all long-term, noncancellable leases and not just those leases which were in substance purchases of property. He argued that the discounted

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[9]Accounting Principles Board, American Institute of Certified Public Accountants, "Reporting of Leases in Financial Statements of Lessee," Opinion No. 5 (New York: American Institute of Certified Public Accountants, 1964), p. 29.

[10]John H. Myers, "Reporting of Leases in Financial Statements," Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), p. 4.

[11]Ibid., p. 5.

future payments under a lease contract are assets to the lessee "... to the extent that they represent the acquisition of the right to use property."[12]

Others have offered the opposite opinion with respect to the capitalization of payments due for leases. Zises did not believe that lease obligations were sufficiently valid forms of indebtedness, at least not to the extent that capitalization was required. He considered future lease payments more analogous to contingent liabilities which could be reported adequately in a footnote disclosure.[13]

Cook examined some of the legal ramifications of leases and suggested that leases are more similar in nature to executory contracts than to long-term debt. The lease is not an immediate conveyance of all property rights, he argued, and to arbitrarily establish asset and liability values would be an inconsistent approach to accounting.

> The liability of the lessee to pay the rentals thus accrues only with the passage of time, and the future property rights and related obligations are off-setting and cannot properly be recognized in balance sheets intended to reflect present financial condition.[14]

His opinions were primarily directed towards Myers' research study. Cook did not agree that accountants should adjust the balance sheet to reflect the capitalized value of the property rights. Instead, Cook urged footnote disclosure, since if adequate information is provided in a footnote or supplementary schedule, the analyst can apply

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[12] Ibid., p. 38.

[13] Alvin Zises, "Long-term leases: A Case Against Capitalization for Full Disclosure," Journal of Accountancy (February, 1961), pp. 37-47.

[14] Donald C. Cook, "The Case Against Capitalization of Leases," Harvard Business Review (January - February, 1963), p. 157.

his own techniques to evaluate the particular entity.[15]

In September 1964, the Accounting Principles Board issued Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee." This directive followed Myers' Accounting Research Study No. 4, and attempted to clarify the distinctions between the types of leases described in earlier bulletins. The central problem which the opinion covered was "... whether assets and liabilities are created by leases which convey the right to use property if no equity is accumulated in the property by the lessee."[16]

The Board decided that those leases which provided the right to use the property are nothing more than executory contracts which only require continuing performance by both parties:

> ... the right to use property and a related obligation to pay specific rents over a definite future period are not considered by the Board to be assets and liabilities under present accounting concepts... In the opinion of the Board, disclosure rather than capitalization is the correct accounting treatment of these leases.[17]

The opinion suggested, however, that those leases which are in substance installment purchases of property should be recorded as assets and liabilities, and stated in the balance sheet at the appropriate discounted value of future lease payments. Thus, Opinion No. 5 categorized long-term leases into two separate classes; leases which are installment purchases of the property, and leases which provide the right to use

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[15] Ibid., p. 161.

[16] Accounting Principles Board, Opinion No. 5, p. 29.

[17] Ibid., p. 32.

the property. Recommended accounting procedures are provided for each category. Those leases which are purchases of property (hereafter referred to as purchase equivalent leases) should be capitalized and the amounts reported among the assets and liabilities, and those leases which convey only the right to use the property (hereafter referred to as right to use leases) should be disclosed in footnotes to the balance sheet.

Canadian Reporting Practice

There has not been as much concern for the reporting problems of long-term leases in Canada as there has been in the United States. However, several articles, which discuss disclosure in general terms only, have been published in Canada.[18] The Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants has not issued a bulletin on long-term lease disclosure exclusively, but has provided a suggested method of financial statement presentation in Bulletin No. 20.

> Desirable information in respect of long-term leases includes disclosure of the type of property leased, the maturity date or dates, particulars of renewal clauses or options at maturity, the amount of rental paid during the current period if this has not been disclosed in the statement of profit and loss, the amounts of minimum annual rental to be paid under such leases together with indication of the existence of special features, such as percentage-of-sales clauses. In the year in which the transaction is effected, the principal details of any sale and leaseback transactions, including the disposition

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[18] F. A. Hughes, "Accounting for Leaseback Transactions," Canadian Chartered Accountant (May, 1958), pp. 335-38. D. Bonham, ed., "Accounting Research: Long-Term Lease Disclosure," Canadian Chartered Accountant (November, 1964), pp. 361-63. Glen C. Speakman, "Impact of Lease Obligations to Lenders," Canadian Chartered Accountant (March, 1966), pp. 221-23.

of any gain or loss on the transaction, should be given.[19] The Committee has not discussed the capitalization method of lease disclosure but has suggested footnotes as the only accepted approach. The accounting standards provided by the bulletin are not only narrow and incomplete but are also outdated in terms of current American practice.

The Problem

The long-term lease has been an effective method of allowing an entity to acquire the possession and use of property for extended terms, while avoiding the necessity of disclosing these leased assets and related liabilities on the balance sheet. The problem to be considered in this paper is whether or not the property rights and related liabilities acquired through long-term, noncancellable leases should be capitalized and reflected among the assets and liabilities of the entity for improved financial statement disclosure.

Methodology

The methodology is a combination of the deductive and empirical approaches. The deductive method provides the conceptual basis for the capitalization process as an approach to long-term lease disclosure. The empirical methodology consists of two mail questionnaires. The first questionnaire was directed to the financial officers of those

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[19] Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, "Bulletin No. 20, Standards of Disclosure in Financial Statements," Accounting and Auditing Practice (Toronto: Canadian Institute of Chartered Accountants, 1964), pp. 9-10.

companies using long-term leasing (hereafter called the company questionnaire). The second was directed to a selection of financial analysts across Canada (hereafter called the analyst questionnaire). As well, a review of the annual reports of those companies using long-term leasing was conducted to determine the reporting practices commonly employed in Canada.

The descriptive mail survey was used to gather information with respect to Canadian attitudes on capitalization of long-term leases, and to provide practical support to the problems discussed. The questionnaires reflected the opinions of the analysts and companies surveyed as to the proper reporting of long-term leases and the improvements deemed necessary in financial statement disclosure. In reviewing the various annual reports of the companies using long-term leasing, many of the weaknesses of disclosing long-term leases in footnote form were revealed to be present in Canadian disclosure practice. The results and analysis of the survey are presented in chapter two, and the summaries of the replies to each question are included in the appendix.

Limitations of the Study

This study accepts and employs the principles, postulates and constraints of accounting theory to evaluate the problems of long-term lease disclosure, and to guide the observations on the ability of the conceptual accounting process to classify business activity. The main purpose is to prescribe procedures or techniques for solving the operational problem of long-term lease disclosure. The investigation is thus concerned with deciding between the alternatives suggested by the

normative study in a practical context and to determine if it is possible to manipulate the financial statement disclosure of leases to better satisfy the objectives of accounting. If a recurring pattern of behavior is apparent on the part of the users of financial statements, then these attitudes may determine the applicability of current principles and practice in communicating information to decision makers. However the criteria of success in this study will tend to be the selection between methods of accounting application, rather than the development of laws or theories which may explain the implied or explicit accounting relationships between various concepts.

The use of a mail questionnaire to gather supporting information introduced several weaknesses into the study which were peculiar to the survey technique itself. A terminology problem was encountered, and although those surveyed were presumably acquainted with the financial activities of their firm, many were not familiar with the definitions and procedures of capitalization. This restricted the extent of the questionnaire pretest and likely affected the number of responses received. Many of the "open-end" questions were not completed, presumably because of the special knowledge required to provide an adequate reply. This was typical of the replies received from both the analysts and the companies.

Since the survey was national, it was difficult to obtain a high percentage of responses. The follow-up contacts were limited to letters alone. In the case of the company questionnaire, the selection of companies was not random but restricted to those firms actually employing long-term leases as indicated by their financial statements. The

analyst survey was directed to the head offices of those financial firms considered to be users of financial statements and generally familiar with leasing problems.

The study is mainly concerned with those long-term, noncancellable leases extending over three years, with the exception of natural resource leases which are not considered. Finally, the accounting problems peculiar to the lessor will not be examined.

Chapter II

METHODOLOGY AND RESULTS OF QUESTIONNAIRE

Methodology Overview

This study reviews the previous writings and concepts on the topic of long-term lease disclosure in an attempt to present the alternatives in accounting practice. By presenting the assumptions and the alternative accounting approaches, the general framework for the study can be described. The essential problem to be considered is whether or not long-term, noncancellable leases should be capitalized at the present value of the future rental payments under the lease and these amounts included among the assets and liabilities of the firm as a method of financial statement disclosure.

If accounting provides the conceptual framework to classify and record the monetary transactions of the firm, then as business activities and practices change, the classification system must be examined to determine if new types of transactions can be accommodated within the existing classification scheme. Central to the conceptual scheme of accounting designed to classify data, is the availability of definitions which will provide some rules and procedures by which the observations can be classified or identified. The approach in this thesis is to examine the suggested practice and the relevant accounting definitions or generalizations and the application of accounting principles to the classification and identification of long-term lease transactions.

As well as examining the suggested accounting affecting long-term lease disclosure, this thesis will also employ a mail questionnaire

to examine the attitudes of some financial executives. The survey is used to provide some attitudinal information on the specific problem of long-term lease disclosure. The intention of the questionnaire is to examine the opinions of some financial officers regarding long-term lease disclosure and to evaluate the types of information needed by the users of financial statements in this area of financial reporting. The survey may provide a basis for prescribing procedures to improve upon any apparent disclosure inadequacies from a Canadian point of view. At present, there is little data available for use in guiding the application of present accounting techniques, or for a basis to suggest changes in accounting practice. It is therefore difficult to appraise the presently accepted accounting practice for long-term leases to determine if this disclosure satisfies the objectives of accounting. The data provided by the questionnaire may indicate some of the lease information desired by these analysts or the attitudes of those people using accounting information for decision making purposes, particularly in the context of lease financing.

The thesis examines the suggested accounting practice for long-term leases, while the questionnaires serves as the source of information which can be used to evaluate the alternative solutions to this special accounting problem. The questionnaire is used to add to the descriptive data available on the characteristics of these leases. As well, the questionnaire may indicate if the prescribed accounting practice can be made operational, however it is not used as a device to test any particular hypothesis concerning accounting theory.

QUESTIONNAIRE SURVEY TECHNIQUE AND RESPONSE

Two separate questionnaires were used to gather attitudes, and these were sent to those firms who were familiar with long-term lease arrangements. The company questionnaire was mailed to those corporations actually employing long-term leases and disclosing the lease details in the footnotes to their financial statements. This company list was prepared largely from information supplied by the Canadian Institute of Chartered Accountants and partly from a review of the annual reports of many Canadian public companies. Ninety-one company questionnaires were circulated. Of this number, seventeen were returned unopened and three were returned incomplete and not useable. Twenty-three company questionnaires were received which were useable and these were thirty-two percent of the total company questionnaires sent, minus the number undelivered, returned or not useable.

The analyst questionnaires were directed to those firms believed to be users of financial statements, who would presumably use accounting information for various types of investment or appraisal decisions. The list was composed of most of the major Canadian financial companies, including: the chartered banks, the large trust companies, life insurance companies, mutual fund companies, and brokerage firms. The analyst questionnaire was sent to eighty-eight firms, of which twelve were returned undelivered or incomplete. Thirty-three analyst questionnaires were returned, of which three were not useable. The final response rate from the analysts, after three months, was forty-one percent.

Both questionnaires were pretested in Edmonton on a limited basis, but it was difficult to receive much co-operation, particularly from the local investment firms. Certain recommendations and criticisms were received and these were reflected in the questionnaires where appropriate. One month following the first mailing of the questionnaires, follow-up letters were sent to those firms who had not replied. This helped to increase the response rate, since some firms had misplaced the questionnaire during the month, as a result of the flood of mail following the 1968 national mail strike. A summary of the questionnaires circulated and the respective response rate is included in Table I, and also in the appendix, page 144 . Copies of the two questionnaires circulated are included in the appendix, as well.

TABLE I

Responses to Questionnaire

	Company	Analyst
Total number of questionnaires mailed	91	88
Number returned undelivered or not completed	17	12
	74	76
Number received but not useable	3	3
	71	73
Number completed and useable	23	30
Total completed as a percentage of total sent out minus number undelivered and not useable	32%	41%

QUESTIONNAIRE RESULTS

General

The majority of the questions in both questionnaires were closed form, where several choices were suggested and the respondent answered by checking the alternative with which he agreed. As well, these questions required the respondent to elaborate on the initial reply which provided some indication as to the respondent's understanding of the problem. In other questions in which attitudes or some particular behavior was requested, the questions were open form in which the respondent replied in his own words.

The method of summarizing the data for analysis was to count the frequency of replies for each question and to note the reasons provided by the respondent. In most questions the popular choice was quite obvious, and these responses receiving the majority of the respondents' votes were considered to be the most important attitude of the total group replying.

Where the question was intended to provide information on the characteristics of leases, the frequency of answers was not an important guide to the respondents' attitudes, since each lease has its own peculiarities in each situation. However, even in these questions there were usually one or two popular replies evident. These latter questions dealt for example, with such matters as the advantages, or disadvantages of leasing.

The results of the survey as indicated by the respondents' opinions on each question of the two questionnaires are summarized in the appendix to the thesis.

Company Questionnaire: Respondents' Views

The company questionnaire provided a description of long-term lease characteristics from a user's point of view. The most widely accepted reason for employing long-term leasing was that the lease required less capital outlay initially than other forms of long-term financing. As well, the long-term lease permitted the lessee to avoid the loss in asset value through the rapid obsolescence of the item. The income tax advantages which existed under a long-term lease were considered as the third most important reason for employing lease financing.

Most companies agreed that long-term leasing expanded the entity's total available credit. It appeared, that of the companies reviewed, leasing also permitted the lessees to avoid the covenants of their bond indentures, particularly concerning the restrictions on further long-term borrowing during the period of the mortgage bond. Only three companies of those replying were restricted in the leasing of additional fixed assets, and one company's lease contract precluded the addition of further bond indebtedness during the period of the lease.

The cost of leasing in comparison to other forms of long-term debt was higher in seventy-seven percent of the company replies. This was due to the greater lessor risk involved and the implications of the Canadian bankruptcy law, which limited the lessor's preferred credit ranking for damages or rental arrears. One respondent suggested that the higher cost of leasing was, in his opinion, due to the fact that some finance companies directed their leasing services to those companies with a greater risk of insolvency and thus the interest rate is higher in general. Fifty-three percent of the companies replying

weighed the interest charge as an important factor in the overall appraisal of the financing arrangement, while forty-four percent gave considerable attention to the lease interest rate during lease negotiations.

One of the questions which was common to both the company and the analyst questionnaire concerned sale and leaseback arrangements. When asked if they believed any difference existed between sale and leasebacks versus other long-term leases, sixty-five percent of the companies replying indicated there was a difference, while fifty-five percent of the analysts replying did not see any basic difference between the two long-term lease arrangements.

If the company or analyst replying believed a difference existed between sale and leasebacks and other long-term leases it was mainly because a conventional lease arrangement did not provide for the same purchase options at maturity, in which case residuals may be lost to the lessee. Other reasons given for the difference, suggested that sale and leasebacks were closer to secured borrowing than conventional leases, and the sale and leaseback was more of a deliberate attempt to arrange "off-balance sheet" financing, whereby neither the asset nor liability amounts would be directly reported on the entity's balance sheet.

Before entering into a lease financing commitment, fifty-three percent of the companies replying indicated that they used some formal analytical technique to determine economic consequences of each financing opportunity. These techniques were either present value calculations or discounted cash flow analysis. If no analytical technique was employed these companies considered leasing as an alternative if

it provided some specific advantage not otherwise available through other financing forms, such as the acquisition of a special type of asset.

While seventy-six percent of the respondents to the company questionnaire believed that leasing should continue to strengthen and become more important as a method of long-term financing, several disadvantages were inherent in this method of acquiring fixed assets. The greatest disadvantage reported by thirty-eight percent of the companies replying, was the higher cost of lease borrowing as compared to other forms of long-term financing. Since the lease is generally noncancellable and the payments quite rigidly set, thirty-three percent of these companies considered the loss of flexibility as a result of a long-term lease to be a serious disadvantage. As well, there was the loss of any possible appreciation in the asset's value particularly with respect to land, since the lessee normally gave up any asset residual remaining at the maturity of the lease.

Analyst Questionnaire: Respondents' Views

The long-term lease, as viewed by the analysts who replied to the questionnaire, was considered to be one of the conventional sources of long-term financing, as measured by the certainty of return on investment and the recovery of the principal. It was one source of borrowing available to the corporation and these analysts considered leases most often to be less secure than mortgage debt but more secure than unsecured debentures. Ninety-six percent of the replies received from the analysts considered long-term, noncancellable leases to be more secure than preferred or common stock on the basis of return on

investment and the lessor's security.

The analysts indicated several conditions which determined their ranking of long-term leases with other debt forms. Thirty-nine percent of the analysts felt that the comparability with debt would be dependent upon the nature of the property leased. Sixteen percent mentioned the lessee's credit as an important factor and several suggested that if a company could lease it could borrow as well. One condition of leasing, which sixteen percent of the analysts believed reduced the comparability of the lease with debt in terms of security of the investment, was the implication of the laws of bankruptcy. These laws could reduce the lessor's security with respect to return on investment if the lessee's business should fail. This latter reason explained why the lease generally commanded a higher interest rate over other forms of borrowing, at least in the opinion of fifty-six percent of the analysts who replied. The most important factor in determining the security of the lease was, however, the credit of the lessee, secondly the nature and value of the property leased and thirdly the term of the lease.

One of the important questions, included in both questionnaires, asked the respondents to indicate if they were in favour of the capitalization of long-term leases and the disclosure of these amounts among the assets and liabilities of the firm. Of those replying to both questionnaires, fifty-two percent were not in favour of this form of long-term lease disclosure while twenty-nine percent were in favour of this practice. However, nineteen percent of the replies indicated that their decision to capitalize the future rental

payments under a lease would depend upon the various circumstances of each lease. The popular circumstance as indicated by those respondents who were undecided was whether or not the lease provided the lessee with an arrangement to purchase the asset.

Those who favoured the capitalization process suggested that improved comparibility between corporations would be effected, which should ensure more consistency in the minimum amount of information supplied by the financial statements. Moreover, they indicated that since leasing is one form of long-term debt it should be disclosed as such.

Most respondents who were not in favor of the capitalization principle reasoned that footnote disclosure was adequate for their purposes, particularly since the capitalization process involved many subjective decisions which may or may not improve the accounting information provided by the firm.

The next set of questions considered the mechanics of capitalization and solicited the opinions of the analysts regarding the nature of those leases to be capitalized. Sixty-five percent of the analysts agreed that the amount of the future lease payments, less any portion of the rentals for service costs, should be the annual amount to be discounted over the term of the lease. Forty-eight percent stated that they believed the rate of discount should be the interest rate of the specific lease agreement, if known, or secondly the company's cost of capital.

The type of asset appears to be an important factor in determining whether or not a long-term lease should be capitalized. Real

property leases involving real estate, buildings and branch sales offices should be capitalized whereas automotive equipment, machine tools or computing equipment should not be shown directly on the firm's balance sheet. Generally those leases which extend over a minimum of three years are suggested for capitalization, since this term qualifies the lease for long-term status.

The analysts replying indicated that they would like to see more information provided on the long-term leases of a corporation. Specifically, sixty-seven percent of the analysts requested that more footnote information should be shown, as outlined by Bulletin No. 20.[1] Thirteen percent indicated that the lease commitments should be capitalized and shown in the footnotes to the financial statements. Other suggestions for the improved disclosure of long-term lease information included: leases with subsidiary companies and the interest rates of the leases.

One other observation was possible from a review of the analyst questionnaires. The analysts were requested to indicate any of the analytical methods they employed to evaluate the impact of long-term leases on an entity's financial position. The most common reply from thirty-nine percent of the analysts was that rental charges were included in the other fixed charges such as bond interest, to determine the cash flow and earnings coverage. Secondly, the analysts indicated that they would often discount and capitalize in some way the amount

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[1]Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, "Bulletin No. 20, Standards of Disclosure in Financial Statements," Accounting and Auditing Practice (Toronto: Canadian Institute of Chartered Accountants, 1964), pp. 9-10.

of all future rentals under the lease, to arrive at an estimate of the asset and liability presumed to attach to the lease.

However, after replying to this question, the analysts were asked to perform the calculations with a set of data provided for their analysis. Very few of the analysts attempted to capitalize the future stream of rental payments. From this it may be suggested that either the calculations would have required too much time and effort, or the analysts did not actually understand and carry out the capitalization calculations which they had earlier acclaimed as usual analytical techniques. As such, this question provided little information on the techniques employed to evaluate long-term lease obligations.

ANALYSIS OF THE QUESTIONNAIRE DATA

Company Questionnaire

The respondents to the company questionnaire presented some additional information on long-term lease characteristics and peculiarities. The companies described their attitudes and current experiences with this form of long-term financing, which were useful to explain or clarify some of the reasons why corporations would finance through long-term leases.

The companies felt that leasing was a source of financing for the acquisition of fixed assets. The method was, however, more costly than conventional debt sources and may place the corporation in a less flexible position than if the asset had been purchased. However the fact that a reduced cash outlay was required initially was an important advantage of these lease arrangements.

One of the important peculiarities which still attaches to long-term leases, at least in Canada, is that through lease financing the restrictive covenants of existing debt can be avoided. Only a small percentage of the companies who replied have indenture covenants restricting further fixed asset additions through long-term leases. Thus for some companies, the lease provides an opportunity to avoid these restrictive covenants while still acquiring more fixed assets. This may suggest that leasing is not yet viewed as comparable to other forms of borrowing by Canadian investors, even though the obligation to pay the rental charges is just as binding a commitment to the company as are bond charges.

Sale and leaseback arrangements are considered to be somewhat different from conventional long-term leases primarily because of the lessees options at maturity. In a sale and leaseback it is normally provided that the lessee will have the option to purchase the leased asset at maturity, while with a conventional lease any residual value is lost ot the lessee. The difference is particularly stressed by the companies replying to this common question, and this may suggest that as lessees they are willing to forego title to the asset over the term of the lease, providing the maturity options allows the lessee to reclaim the asset. The remark of one respondent indicates that the sale and leaseback is essentially a deliberate attempt to arrange "off balance sheet" financing. If the sale and leaseback is but a method of providing long-term financing by the sale of an asset originally owned by the company, and whose use is retained and guaranteed by the lease contract, then the objectives of accounting can best by met by their

disclosure directly on the balance sheet. This would provide a better indication of the assets employed by the firm, while fixing the amount due to the lessor under the sale and leaseback contract. The sale and leaseback, with a purchase option at maturity, appears to be a contrived financial device which to some extent does eliminate several of the disadvantages of conventional lease financing, particularly the loss of the residual value in the land or the building itself. As well, the corporation uses an asset designed to its own specifications and it may be in a better position to secure this form of lease financing at more competitive rates.

Analyst Questionnaire

The analysts generally agreed that lease financing was comparable to other forms of long-term debt. The lease was negotiated under the same criteria required for mortgage borrowing. The general credit worthiness of the lessee was believed to be an important factor in providing lease financing as well as the nature of the property leased. However the implications of the bankruptcy law, which reduced the lessor's certainty of return on investment, tended to increase the cost of leasing relative to mortgage debt.

On the basis of the attitudes of both the companies and analysts, there is no need to capitalize all long-term noncancellable leases as a method of disclosure. They did indicate, however, that they would consider some types of leases for capitalization and direct reporting. These leases would provide the lessee with some equity in the asset leased, as in a sale and leaseback, and would be leases of real property extending over three years.

While the respondents do not appear willing to accept a conventional long-term noncancellable lease as another form of secured borrowing, they do seem to realize that little difference exists between owning a fixed asset with an established, specific liability and leasing an asset with a similar attached obligation. This observation coincides with the opinions given by both the companies and analysts on sale and leaseback arrangements. It seems that most practitioners separate and classify long-term leases between those that provide purchase options and those that do not and also between those leases concerning "solid" assets, found in real estate leases, and those leases for computers of machine tools. It therefore seems reasonable to suggest that the capitalization of those leases which are in substance purchases of the property by the lessee is warranted as an acceptable method of disclosure. However the capitalization of other long-term, noncancellable leases is not recommended as a disclosure procedure.

Of the possible alternative methods of disclosing long-term leases, the general opinion of the respondents is that capitalization of those leases which are more clearly purchases of the asset is preferred. This alternative may be a compromise between the other disclosure methods of complete footnote disclosure at one extreme and the complete capitalization of all long-term, noncancellable leases at the other. The lack of any consistent pattern of disclosing long-term lease information in footnotes requires that more information be presented, as is shown by the large number of replies suggesting that more data be provided on these leases. However the additional information provided by the complete capitalization of all long-term leases

is not necessarily needed by the analysts. Two possible explanations for this are suggested: either the effect of these amounts on the financial position and income statement is not material and can be extracted from other sources, or the analysts do not believe that long-term leases, other than those which are purchase arrangements, are quite as comparable to long-term debt as to require disclosure by direct capitalization.

The mid point between the two extremes of disclosure is the capitalization of those leases which are essentially purchases of the assets. Since this classification generally includes assets with a greater value to the entity, then the objectives of accounting can better be met by the direct reporting of the present value of the future rentals under the lease, as an asset and a liability on the balance sheet of the firm. The analysts and the companies replying agree that these leases are special financing arrangements which allow some organizations to obtain the use of usually substantial assets without disclosing the total resources employed, or the claims against the entity, as represented by the obligation to pay rentals for a fixed period. Presumably the effects of the lease charges on the entity's income for the period and the timing of the charges are considered more material in a purchase arrangement lease, and the capitalization approach to lease disclosure allows the company to account for and classify the leased assets on a basis comparable to other owned assets. This method increases the comparability between firms, introduces more consistency to the disclosure, and improves the measurement of the changes in assets and liabilities employed by the firm. With capitalization of those leases which are in substance purchases of the property, the

decison makers employing the accounting information can better interpret the results of the operation of the company as provided by the financial statements. Certainly the accounting practice now employed does not appear to provide the most useful information relevant to good decision making.

Summary

The questionnaires provided attitudes on long-term leases, as held by financial executives in Canadian corporations employing lease financing or employing accounting information for various types of investment decisions. The significant characteristics and features of the typical Canadian financial lease were summarized as being: (1) a financing device comparable to other debt forms; (2) generally more costly than other types of debt; (3) a useful device to avoid restrictive bond indenture covenants; and (4) requiring less capital outlays initially. Sale and leasebacks were considered to be special types of financial leases, in which case the maturity options offered the lessee the privilege of reclaiming the asset and the residual values. The lease in this case more closely parallelled a conventional debt form.

The capitalization of all long-term, noncancellable leases was not suggested as a uniform method of disclosure by the questionnaires. However the survey indicated that there was support for the capitalization of those leases which were in substance purchases of the assets. Those surveyed realized the special significance of these leases, which provided a purchase arrangement and the improvement in the disclosure of the resources employed by the entity and the claims against it if the lease amounts are disclosed directly on the balance sheet.

Chapter III

FINANCIAL ASPECTS OF LONG-TERM LEASES

Introduction

The accounting analysis which follows will require some understanding of the objectives and peculiarities of long-term leasing. Much of the terminology of leasing is of a legal nature, since the lease is a contract and the parties to the lease are subject to the existing laws, both common and statute. As a result, the historical evolution of the lease is largely a legal evolution, whereby the use and interpretation of the lease is traced from its early, rural applications to its recent uses as an urban, financing arrangement.

Many advantages have been suggested for leasing to account for the increased application of the lease in the area of long-term financing. A theoretical analysis of the long-term lease will reveal certain of these advantages to be more illusory than beneficial and will show these advantages to be partly a result of the accounting procedures used and partly a result of a poor understanding of lease financing. Also the disadvantages implicit in a leasing arrangement will be considered. Throughout this chapter, where appropriate, the results of the Canadian mail questionnaire conducted on long-term leasing will be included. This will introduce a Canadian perspective to the discussion on long-term leasing.

Income tax considerations, as they pertain to leasing, will be examined, since some of the advantages of leasing hinge on the interpretation of the tax laws at the time. Does the lessee receive any

benefits by leasing which are not available to an owner under the taxing legislation? The lessee is presumed to receive some tax relief, for example, by charging all the rental payments to income, which in essence allows him to write off the cost of land, a benefit not allowed an owner. This chapter will consider the effects of taxation on lease arrangements in a Canadian context. Just as important will be the discussion on the effects of bankruptcy law on the security of the investment in long-term leases, often cited as a disadvantage of this type of arrangement.

This chapter will therefore explore the institutional background of leasing in both a theoretical and practical context. The understanding of leasing in this broad, financial perspective will serve as a preface to the narrower problems to be found in the accounting discussion to follow.

Historical Background

The lease became an important device early in England's history, when large landowners contracted for the working of their lands by tenant farmers. In its earliest form, leases were urban, agrarian, land contracts. These agricultural leases "... were primarily of contractual significance, rather than of property significance."[1] Between the twelve hundreds, when the lease first appeared, and the fifteen hundreds, the "... interest of the lessee came to be regarded as an estate in land, and the lease was asserted to be essentially a

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[1] Richard R. Powell, The Law of Real Property (New York: Mathew Bender and Company, 1966), II, p. 177.

convyance [sic] rather than a contract."[2] The conveyance of the estate took place at the outset of the contract, when the leasehold was delivered to the tenant.

During the past century in the United States, the lease has grown from its English, rural background into a sophisticated urban financing arrangement. Some of the early English background and the legal implications can still be seen in United States practice; however for the most part the business lease has become more common and of more social importance than the agrarian lease. The current interpretation of the law of real property affecting land leases has evolved as well, and the contractual implications of lease covenants, rather than those of conveyance, are stressed.

The Evolution of the Lease in the United States

The first use of the lease in the United States was in Maryland in 1883.[3] In this early example, an asset was transferred between two people, and this exchange was to be renewable forever in return for an agreed annual rent. Powell observed that even in the early years of American history the advantages of the lease were evident:

> The conveyor secured a conservative return from his land interest, and the conveyee secured either a business or, more commonly, a house site without a capital investment. In this form, the long-term lease is substantially the equivalent of a mortgage without a principal due date.[4]

As a flexible financing method, the lease continued to grow rapidly from 1900, and has seen an increased use in the business

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[2] Ibid., p. 179.

[3] Ibid., p. 372.13.

[4] Ibid., p. 372.13.

community. This may be in part as a result of urban real estate developments or possibly as a result of income tax advantages believed to exist in leasing arrangements. However, long-term leases are currently used for purposes other than real estate financing and income tax minimization. They are commonly employed in natural resource industries to acquire development property. They are used as an alternative to the purchase of cars and trucks, and as a means of obtaining other expensive equipment, such as electronic computers. At the present, almost any type of asset can be acquired through a lease transaction. The Wall Street Journal[5] reported that one large leasing company had contracts out covering such things as metal beer kegs, tug boats, an aluminum extension press and hotel soap racks. Niehuss summarized the lease's versatility:

> ... out of its long and varied history, during which the lease focus has been changed and remodelled to meet changing conditions and purposes, it has acquired the capacity for adaption to many purposes and to meet various and widely different circumstances.[6]

CHARACTERISTICS OF LONG-TERM LEASES

Legal Definitions

It is not possible to prepare a list of features and to hope that it will embrace all lease variations, since the lease is very versatile and each one is different from the next. It is possible,

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[5] Wall Street Journal, January 22, 1959, p. 1.

[6] Marvin L. Niehuss and Ernest M. Fisher, Problems of Long-Term Leases, Michigan Business Study, Vol. 11, No. 8, p. 3, quoted in Powell, Real Property, p. 372·13.

however, to look at some of the characteristics of general importance, particularly those applicable to the accounting presentation.

The lease is the legal document conferring the right to the exclusive possession of an asset, and, as a legal document, its basis is in the statutes and common law of the country. The relationship of the parties to the agreement is a matter of contract, and this relation is legal and governed by the law of real property, in the case of real estate[7], and the laws of personal property and bailment, in the case of chattels. Bailment considers the relationship which exists when one person, the bailor, delivers a chattel into the custody of another, the bailee, for return at a later date. The fact that the bailee must return the asset indicates temporary possession of the asset. A hire, with option to purchase, provides the bailee with a purchase option at some time during the lease, or at maturity. "It differs from a contract of sale at a price payable by installments in that the purchaser has no option to terminate the contract by returning the chattel ..."[8] Williams defines the lease as:

> ... a conveyance of lands or tenements for life or lives, for years or at will, but always for a less term than the party conveying himself has in the premises, for if it be for the whole interest it is an assignment not a lease.[9]

The tenant's or lessee's interest, created under a lease, is known as leasehold estate, but is more commonly referred to as a leasehold.

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[7] William Henry Anger, Anger's Digest of Canadian Law (17th ed., Toronto: Cartwright and Sons, 1957), p. 221.

[8] *Ibid.*, p. 221.

[9] E. R. Williams, Notes on the Canadian Law of Landlord and Tenant (Toronto: Carswell Book Company Limited, 1934), p. 39.

The sale of a piece of property, in contrast, would be an estate in fee simple, which gives the owner a potentially indefinite duration of ownership rights. Powell states that "... in almost any jurisdiction, opinions can be found saying in substance that the estate in fee simple is the greatest or most exclusive interest which can exist in land."[10] The lessee enjoys many of the same benefits of asset use as does the owner in fee simple, notwithstanding that title has not passed. The lease is very similar in nature, by some arguments, to a conditional sales contract, in which case the parties to the contract agree to "... a change of possession without a transfer of title until the condition precedent is fulfilled."[11] The vendor maintains title to the asset until the "condition precedent," or complete payment under the terms, has been met. The purchaser receives the user's rights to the asset and can include the asset at cost among the balance sheet items, together with the respective liability due to the vendor under the conditional sale contract. It may be argued that there should also be an accounting parallel for better financial statement disclosure.

Leases and the Statute of Frauds

Leases, as contracts in general, are covered by the Statute of Frauds,[12] an act which sets down conditions for written contracts, as distinguished from oral contracts. Various classes of contracts, if not in writing, are not enforceable upon a dissenting party, nor can

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[10] Powell, Real Property, p. 18.

[11] A. H. O'Brien, Conveyance, Law, Forms and Precedents (Toronto: Canada Law Book Company, 1955), I, p. 302.

[12] Canada, Statute of Frauds, SS land 2,29. Car. 2, C.3.

any party maintain an action for specific performance, and the contract is void. In the case of leases, the Statute of Frauds, requires that those leases:

> ... exceeding the term of three years from making, must be in writing and signed to be enforceable contracts. Short term leases, that is, those less than three years can be oral contracts and still be enforceable.[13]

This is one authority which suggests three years as a minimum length for a lease to be considered long-term.

Other Legal Implications

To be a valid lease, the document must contain other legal requisites.

> It is necessary that a lease should contain (1) proper parties, (2) a description of the premise demised, (3) the commencement, and (4) duration of the term, (5) the rent, if any, (6) all the material terms of the contract not being matters incident to the relation of landlord and tenant, including any covenants or conditions, exceptions or reservations, as well as (7) words of present demise.[14]

The word "demise" is important to a proper lease; its essence also has bearing in an accounting context as well, To demise means to convey a freehold, and it is equivalent in meaning to the infinitive to grant, or to transfer. It is required that the appropriate words, therefore, are included in a lease, which explains the intent of the parties. One shall divest himself of the possession of the asset and the other shall receive it for a determinate period. The asset is conveyed specifically to the lessee, who has user's rights to the asset for the term, without

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[13] Ibid.

[14] Williams, Notes on the Canadian Law of Landlord and Tenant, p. 16.

interference from the lessor.

Further, there are several implied covenants to a lease which provide the lessee with other ownership privileges, besides the conveyance feature. The lessor, even in the absence of an expressed covenant, agrees to provide the lessee with the uninterrupted use of the asset. This is referred to in law as the "quiet enjoyment" of the asset.

> The covenant for quiet enjoyment, express [sic] or implied is an assurance against the consequences of a defective title and of any disturbance thereupon; or of any substantial interference by the covenantor, or those lawfully claiming under him with the enjoyment of the premises for all usual purposes.[15]

It is from this legal privilege of uninterrupted possession that one argument can be made in favor of inclusion of some asset value among the balance sheet items of the lessee.

The lease contract, as it varies from situation to situation, will contain specific clauses to ensure the understanding between parties, especially such aspects as maintenance of property, and payment of taxes and assessments. Either lessee or lessor can assume the responsibility for maintenance, and if the lessor pays these costs, the annual rental paid by the lessee will include an amount to meet the costs of these services. This lease arrangement, often found in rentals of automobiles, for example, is known as a maintenance lease.[16]

> More common, however, is the situation in which the lessee pays for repairs, insurance maintenance, etc., so that the amounts of rental received by the lessor are completely free of such property costs. Leases of

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[15] Ibid., p. 329.

[16] Robert W. Johnson, Financial Management (Boston: Allyn and Bacon Inc., 1966), p. 526.

> this type are generally called "net leases", since the lessor is able to predict the net income from the property leased.[17]

The agreement can provide the lessee with several options at maturity of the contract, such as renewal options or purchase options for a set fee. The option to purchase, if granted at the termination of the lease, brings the leasing arrangement very close to a purchase-financing scheme. A covenant for renewal permits the lessee to renew the lease at the end of the term upon his request. Other specific covenants in the lease may require the lessee to provide adequate insurance protection for the asset or may preclude the lessee from assigning or subletting his tenancy. Many leasing agreements contain what Lazere describes as "hell-or-high-water" clauses, which require the lessees to make the agreed payments to the lessor notwithstanding operational difficulties encountered in the equipment.[18] Lazere considers that through this type of covenant the lease parallels, very closely, an installment sale contract.

Operating and Financial Leases

Vancil distinguishes between operating leases and financial leases and divides all leasing transactions into these two categories. "It is important to note that the distinction between an operating lease and a financial lease does not rest on the length of the contract, but on its cancellability."[19] In an operating lease, Vancil

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[17]Albert H. Cohen, Long-Term Leases, Michigan Business Studies, Vol. XI, No. 5 (Ann Arbor: University of Michigan Press, 1954), p. 39.

[18]Monroe, R. Lazere, ed., Commercial Finance (New York: McGraw-Hill Book Company Inc., 1963), p. 245.

[19]Richard F. Vancil, Leasing of Industrial Equipment (New York: McGraw-Hill Book Company Inc., 1963), p. 9.

points out, there is no "... significant commitment by the lessee to continue to rent the equipment."[20] Thus the lessor assumes one significant responsibility, in that he absorbs the major part of the risk of early obsolescence of the equipment, and for this added service usually expects a higher rental.

A financial lease is merely another way of raising capital. However, as Vancil differentiates the two types, the lessee in a financial lease absorbs risk of obsolescence and other ownership responsibilities.

> The distinction, then, between a financial lease and an operating lease rests upon the type of commitment assumed by the lessee. Where the effect of the terms of the contract is such that the lessee guarantees that the lessor will be able to recover his investment, the primary purpose of the contract is usually to provide a method of financing the lease. Operating leases also provide financing of the equipment, but their major purpose is to shift the ownership risk ..."[21]

Inasmuch as the rentals under an operational lease are recorded only to the extent that they are paid or accrue, no serious accounting problems are presented. It is the ramifications of the financial lease with which the remainder of this study will be concerned.

<u>Sale and Leaseback Transactions</u>

The sale and leaseback transaction is a particular type of financial lease which may be defined as "... a transaction in which the sale is made subject to the condition that the seller simultaneously

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[20] *Ibid.*, p. 55.

[21] *Ibid.*, p. 9.

leases the property from the buyer as soon as title passes."[22] As such, the sale and leaseback is one method of providing long-term, secured financing. The retail sales industry employs this financial method to reduce the amount of capital investment in commercial real estate, which otherwise would command a substantial portion of a firm's capital. In Canada, for example, Loblaw Groceterias Ltd., Goodyear Tire and Rubber Company of Canada, and Cosmos Imperial Mills Ltd. make use of sale and leaseback financing.[23]

Greenfield noted that funds to finance a sale and leaseback are obtained from some external source by the lessor, usually pension or profit sharing funds and often life insurance companies.[24] The sale and leaseback often takes this form, and is sometimes called a "three-party agreement", whereby the funds are not provided by the lessor but are furnished by an outside financial institution.[25] Thus there are three parties to the lease: the lessor, the lessee, and the financial institution who finances the arrangement.

The use of sale and leaseback contracts provides the company with a source of rented capital and is an alternative to mortgage

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[22]Harvey Greenfield and Frank K. Griesinger, Sale-Leaseback and Leasing (New York: McGraw-Hill Book Company Inc., 1958), p. 8.

[23]1967 Annual Reports of the Companies.

[24]Greenfield and Griesinger, Sale-Leaseback, p. 22-23.

[25]A. Tom Nelson, The Impact of Leases on Financial Analysis, Michigan State University Bureau of Business and Economic Research: Occasional Paper No. 10 (East Lansing, Michigan: 1963), p. 8.

financing or long-term debt.[26] The purchaser of the asset (the lessor) expects to earn a return on investment (based on some earning rate) as well as the return of the principal over the term. The following items are considered by the lessor-investor before investing. The lease should allow the lessor: (1) to earn a higher yield, (2) to avoid restrictive bond covenants, (3) to obtain income tax advantages which make real estate more attractive than other types of income-producing investments, and (4) a hedge against inflation. Similarly, certain advantages are open to the seller-lessee, including: (1) a larger percentage of the property value can be financed; (2) income tax advantages in deductions allowed for tax purposes; (3) avoidance of the legal restrictions frequently found in long-term debt contracts; and (4) an additional working capital source.[27]

At least one theoretical disadvantage exists in sale and leaseback financing, particularly where the company has owned the property for any significant period and has been claiming capital cost allowance for tax purposes. If the asset sold under the sale and leaseback was the only asset in its tax class or pool, and the disposal proceeds exceeded the depreciated book value, then the resulting excess up to the original cost of the asset must be recorded as part of the company's taxable income.[28] This additional tax exposure could have an important bearing on the overall decisions as to the method of financing employed.

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[26] Donald R. Gant, "Illusions in Lease Financing," Harvard Business Review (March - April, 1959), pp. 121-123.

[27] Greenfield and Griesinger, Sale-Leasebacks, pp. 36-39.

[28] Canada, The Income Tax Act R.S.C. 1952, C. 148, Amended (Ottawa: Queen's Printer, 1965), Section (20), (1), (b).

The two questionnaires (one circulated to analysts and the other to users of long-term leases) contained a common question pertaining to sale and leaseback arrangements. Both the analysts and the companies were asked if they considered sale and leasebacks to be any different in nature from other long-term, noncancellable leases. The majority of the analysts (55% of responses) considered sale and leasebacks to be no different. However, as a general observation, the analysts suggested that a sale and leaseback is closer to debt than a regular lease, and that it should be considered a method of off-balance sheet financing. The companies considered that a difference did exist (65%) and this was largely explained by the greater loss of residual value experienced by the lessee under a sale and leaseback agreement. (See Appendix p. 149).

Financial Advantages of Leasing Fixed Assets

When a firm requires fixed assets, it may have to seek long-term sources of funds to finance the transaction. Often the choice will be between borrowing and leasing arrangements. Under either method, the firm's objective is to acquire the asset's potential service and as Vancil notes, "... the consideration of a financial lease should begin only after a company has previously decided that the purchase of a piece of equipment is desirable."[29] Vancil analyzes financial leases in terms of a financial decision (that is, lease or borrow) and not as an investment decision (lease or buy). Therefore, leasing,

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[29] Vancil, Leasing Industrial Equipment, p. 93.

in its various forms, is one means of obtaining the right to the use of an asset. The lessee receives the potential, productive services of the asset and because of the contractual nature of the payments under the lease, he has, in effect, purchased the asset.

Cohen provides a frame of reference within which the various advantages and disadvantages of the financial lease can be compared with the peculiarities of other financing schemes.[30] His main concern in deciding on the financing scheme is, "... can fixed assets be utilized to secure financing at a cost lower than the all-capital earnings of the enterprise so that financial leverage may be brought to bear in favor of stockholders?"[31]

> In essence, therefore, the financing by long-term lease may be considered only in the light of the following assumptions: (1) business management feels that there is an opportunity to increase aggregate net income to the equity investors of the enterprise by the utilization of additional assets either in the working capital or fixed assets area, (2) there are numerous ways in which the additional funds may be secured, and (3) one of the methods by which the additional capital can be secured is through the use of long-term leases.[32]

To examine, briefly, long-term debt and long-term leases, several characteristics are revealed to be common to both, as shown in the following schedule.

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[30] Cohen, Leases, p. 75.

[31] Ibid., p. 75.

[32] Ibid., p. 76.

Provisions Common to Bond and Lease Financing

Lease Provisions	Bond Provisions
1. Leasing provides capital for a corporation.	1. Bonds are source of capital for the borrowing corporation.
2. The lease creates a commitment for the entity to make periodic payments over some future time. These payments are the return of lessor's investment and his return on the investment.	2. Bonds require the periodic payments for a period of time, which include: interest - return on investment, and sinking fund - return of investment.
3. Leases sometimes contain a rejectable purchase offer, which enable the lessee to cancel his lease earlier than maturity.	3. Bonds often contain a call provision or right of prior redemption of the debt securities.
4. The money is advanced on the strength of the lessee's general credit as much as on the value of the property. A general credit obligation.	4. The primary strength behind the bond issue is the credit of the borrower. Mortgaged property is of secondary importance. A general credit obligation.

Source: Donald R. Gant, "Illusions in Lease Financing," Harvard Business Review (March - April, 1959), p. 123.

The analysts were asked to rank the financial lease with other long-term capital sources in terms of security of investments. Nine choices were provided ranging from more secure than secured mortgage debt through to common stock. Sixty-five percent of the returns considered the financial lease to be more secure than unsecured debentures. Financial leases were most commonly ranked after secured mortgage debt but before unsecured debentures (39%) (See Appendix p. 154). From this it would appear that the Canadian analysts surveyed agree that long-term, financial leases are comparable to other forms of debt.

One Hundred Percent Financing and Working Capital Improvement

One of the first advantages suggested for leasing of fixed assets is that it requires less initial capital for the down payment than does an outright purchase.[33] By this reasoning, it is shown that long-term leasing provides a one hundred percent mortgage on the asset, whereas under a typical debt arrangement the financing may be limited to some percentage of the value of the security, such as two-thirds on a mortgage loan. The difference in the amount of funds required at the outset of a financing plan favors the lease proposal, apparently since the money released will increase the company's working capital.[34] Thus funds are freed for investment in more productive, current assets, such as inventories, which should generate more profits than those funds tied up in low yielding fixed assets.[35]

Gant suggests that "... most industrial debt financing today is unsecured, since it is based on the general credit of the borrower rather than the pledge of any specific assets."[36] Since the lease is also secured by a general pledge of the company's assets and general credit worthiness, the company should be able to obtain at least a similar amount of financing through a direct loan as it can obtain through a lease arrangement. Normally it is the insurance companies or others

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[33] Lazere, Commercial Finance, p. 240.

[34] Machinery and Allied Products Institute, Leasing of Industrial Equipment (Washington: 1965), p. 42.

[35] Vancil, Leasing Industrial Equipment, p. 12.

[36] Gant, "Lease Financing," pp. 129-30.

who are restricted by government regulation in their investment choices that require the larger down payment.

The same view considers that working capital is freed for other investments by the minimum down payment required under the lease. If this were true, it would not seem to make any difference how the working capital was increased, by leasing, sale of stock or long-term borrowing. Leasing in itself does not provide a magic profit potential. Nelson considers this advantage, and those of a similar nature suggested as advantages for leasing as arguments in favor of using financial leverage, which are just as applicable to the more conventional debt instruments.[37] Vancil considers the claim that leases release working capital for more productive work to be an extravagant exaggeration; "... all that a financial lease does is to provide another way of borrowing money, and the money may then be put to productive uses within the company."[38]

Financial Ratio Improvement

The long-term lease has been suggested as a device for improving a company's financial position, because the current accounting standards allow the disclosure of these commitments in footnote form entirely. In this way a company's capital structure can be simplified, and with a more favorable debt position can secure additional funds through the use of other financing sources.[39] Nelson considers the impact of leases on

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[37] Nelson, Impact of Leases, p. 12.

[38] Vancil, Leasing Industrial Equipment, p. 182.

[39] Cohen, Leases, p. 80.

financial analysis, particularly upon the important ratios commonly employed to appraise a company's position.

> Many important conventional financial ratios are made meaningless by current reporting practices with regard to extensive financial leasing. The ratios which are most affected are those concerned with fixed assets, long-term liabilities and interest charges.
>
> ... Capitalization is a sound process for overcoming the weaknesses in current reporting and for properly reflecting the financial impact of leasing in the financial statements.[40]

There does not seem to be much argument that leasing, as an "off-balance sheet" method for financing, does change the financial position of the firm. Whether this is an advantage for leasing is contentious. What seems more likely is that accountants have not yet recognized the significance that investors and financial analysts attach to the asset value of property rights and to long-term debt and related obligations.

By using footnote disclosure of long-term lease commitments to its advantage, a company can enhance its financial position with a sale and leaseback transaction. Greenfield provides an example:

> ... the leasing company paid the user $500,000 for his machine tools, then leased the tools back to the user for a 60 month term. The aggregate dollar amount paid by the lessee over the five-year period was approximately $625,000. The user applied the proceeds of the transaction to reduce bank debt by 30% and to reduce payables 50% and to reduce accruals by 60% and to increase cash. A current ration of 1:13 became 2:22 after these adjustments.[41]

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[40] Nelson, Impact of Leases, p. 101.

[41] Greenfield and Griesinger, Sale-Leasebacks, p. 8.

The analysts were asked what analytical procedures they would normally employ to appraise the effect of long-term lease payments on an entity's financial position. Of the analysts surveyed, the two most common techniques employed were: (1) as a portion of the fixed charges, to be included in interest charges and debt repayment obligations to determine fixed charges and cash flow coverage (39%) and (2) by discounting and capitalizing in some way the value of all lease payments to be made in the future (32%) (See Appendix p. 162). It may be concluded that the similarity of periodic rent payments to other fixed charges has been recognized by many analysts. Financial ratios are also commonly adjusted by the capitalization of the property rights under the lease, and are more meaningful and objective in each situation. In a related question, sixty-five percent of the analysts agreed that the financial ratios computed from financial statements can be made more meaningful by capitalization of long-term leases (See Appendix p. 163).

Avoidance Provisions

Leasing can be used as a circuitous means to avoid various restrictions, either formal or informal, placed on a company. Besides the avoidance of disclosure of the capitalized lease commitments among the assets and liabilities, a company may avoid: (1) long-term debt covenants on currently outstanding debt; (2) the responsibilities of ownership of assets, including problems of control and rapid obsolescence of assets; (3) typical capital expenditure controls; (4) certain income tax regulations by which the write-off of land costs in the rental payments can be achieved; and (5) dilution of ownership.

Of the five arguments above, avoidance of current debt restrictions has been suggested as a strong reason for lease financing.[42] The addition of fixed assets can be accomplished by avoiding the restrictive clauses of the indenture, and an expansionary policy can still be maintained. Even in the face of declining profits a company can continue to acquire fixed assets through leasing and avoid the sanctions normally imposed by capital budgets or the shareholders themselves. Thus the lease is said to increase the company's pool or available credit.[43] This latter point will be discussed below.

It appears that to a certain extent the financial lease does provide an advantage to the lessee through avoidance opportunities. Normally a company's bond indentures and loan agreements will contain limitations on such actions as incurring additional debt or the reduction of working capital below some level. In the campanies surveyed across Canada, only three indicated that their indentures included any restrictions as to additional fixed asset leases. In two of these cases, sale and leaseback of existing fixed assets was prohibited, and in the third, the net income had to exceed the annual fixed charges, including fixed rental costs. It appears that the restrictions against additional leasing is not yet included in many Canadian bond indentures. Similarly, only one of the companies had any restrictions on the amount of new long-term obligations incurred during the life of the existing lease (See Appendix p. 146). Therefore, the avoidance of restrictive

[42]Vancil, Leasing Industrial Equipment, p. 26.

[43]Ibid., p. 17.

indenture covenants is still possible in Canada through the use of long-term lease financing.

The Lease and Corporate Credit

Zises suggests that the use of long-term leases, in addition to subordinated debentures or mortgage bond, may allow a company to secure additional credit not available in other forms:

> ... commercial bankers and institutional investors who have studied leasing would rather lend to a company that has a moderate amount of lease obligations than to the same company with the equivalent amount of senior debt. This is the reason why a company may generally obtain somewhat more financing ... than through senior debt alone.[44]

"A credit pool refers to the amount of fixed obligations which a corporation has outstanding at any one time," states Vancil.[45] The corporation has an amount of credit available to it, but it is not necessarily utilized to its full extent. This "pool" is composed of credit at various costs, and a company may have an extensive pool of credit available at a high rate even though it may have exhausted its credit potential at the lower rates. Vancil argues a position contrary to Zises, and shows that to view leasing as increasing the company's pool of credit is false. It must be remembered that although a corporation may have use all its available credit at a given interest rate, more credit has always been available at a higher rate.

> The significant question about the effect of lease financing on corporate credit, therefore, does not

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[44]Alvin Zises, "Disclosure of Long-term Leases," Journal of Accountancy (February, 1961), p. 39.

[45]Vancil, Leasing Industrial Equipment, p. 25.

> relate to the size of the credit pool, but to the degree to which the company finds an increased utilization of the pool more attractive than if leasing is not used.[46]

The use of the credit provided by leasing should not be viewed as new credit available to the firm, but as a potential source which has always been available.

This is one instance in which the practical opinion of the analysts surveyed did not agree with the accounting principles proposed. The analysts, when asked if they believed that long-term leasing increased the entity's pool of credit agreed that it did (74%) (See Appendix p. 154). This may reflect a poor understanding of the pool of credit concept and the effect of various interest rates on the amount of borrowing a company may employ.

Other Advantages

There are advantages other than those discussed above, which have proved to be applicable in specific circumstances and which, by generalization, have been applied subsequently to a variety of financing problems. One example is the argument that leasing provides increased corporate flexibility.[47] In some instances, this may be true; however, where a company is bound to make payments under a long-term, noncancellable lease, its financial flexibility may be at a minimum. If the leased asset should prove inadequate, the company is at a disadvantage and could be in a less fortunate position than an owner, who could at least dispose of the asset to secure its residual value.

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[46] Ibid., p. 25.

[47] Industrial Acceptance Corporation, Capital Asset Leasing, Offering Circular, 1968.

In some cases the leasing of fixed assets was a means of obtaining an allowable cost under government "cost-plus contracts," which otherwise precluded the cost of debt or equity as a recoverable expense.[48]

Most articles pertaining to long-term leases provide a list of suggested advantages. Many of the important arguments believed to favor leasing are discussed in this chapter, however, several other proposed lease advantages may be suggested.

(1) Assures more adequate servicing of the asset.

(2) Offers the convenience of making only one periodic lease payment (rather than separate payments for debt service, maintenance costs, insurance, property taxes, etc.).

(3) Pays for equipment out of before-tax savings rather than after-tax profits.

(4) Leaves the normal lines of bank credit undisturbed.

The companies surveyed were asked to select two reasons (from five choices) which best described the basis of their decision to use long-term leasing as a method of financing. The minimum initial capital outlay required under a lease was considered to be the most important advantage of leasing in the opinion of the companies who replied. The hedge against obsolescence afforded the lessee in a lease arrangement was selected as the second most important reason. The income tax advantages were also a significant factor in a lease arrangement (See Table II).

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[48]Zises, Disclosure on Long-term Leases, p. 40.

TABLE II

Ranking of Reasons For Use of Long-Term Leases[a]

	Advantages	Companies		
		Number Ranking First	Number Ranking Second	Mode
1.	Income tax advantages not available with ownership.	2	6	
2.	Requires less capital outlay initially than other forms of financing (i.e. less down payment)	21	7	1
3.	Avoids the restrictions frequently found in loan agreements.	0	1	
4.	Does not appear as a liability on the lessee's balance sheet.	1	3	
5.	Permits hedging of risks, primarily that of rapid obsolescence of asset.	3	7	2
6.	Other	-	2	
	Total	27	26	

(a) Companies were asked to mark first advantage by (1) and second advantage by (2).

LEASES AND THE CANADIAN INCOME TAX ACT

Income tax considerations are always important in any lease proposal. To the lessee, the lease payments are deductible as an operating expense, while the lessor is entitled to an owner's deduction of capital cost allowance based on the tax cost of that asset. In so far as leasing is concerned, the Income Tax Act has certain stipulations which must be followed, and these will impinge on the company's decision to lease or borrow. As Cohen points out,

> if there is to be any real difference in the tax consequences of leasing rather than owning, there must be either some quantitative difference in the dollar amount of the tax deductions to which a lessee would be entitled under the leasing agreement as compared to the amount of tax deductions available to an owner, or an opportunity under the lease agreement to deduct for tax purposes the same aggregate amount within a shorter period of time.[49]

Cohen observes that any implied tax advantages of leasing can only properly be weighed within the framework of the tax laws and interpretations as they exist at the time. The long-run benefits of leasing are therefore speculative and relative to future tax implications. The Canadian Tax Act reflects this fact; the financial implications of leasing are contingent upon the tax law at the time. Prior to 1963, Section 18 of the Act contained special provisions which treated those leases containing an option to purchase clause as purchase arrangements. The rentals paid were deemed to be on account of the price of the asset, as under an agreement for sale contract, and were not treated as allowable expenses. The lessee was permitted, however, to deduct a portion of the deemed capital cost of the asset in computing his taxable income.

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[49] Cohen, Leases, p. 46.

Since 1963, when Section 18 was changed, the lessee is entitled to deduct the entire amount of rental payments for the year, "... providing the outlay or expense is reasonable in the circumstances."[50] As Cohen mentions, "in order that the full tax benefits may be obtained, the rentals paid under long-term leases must be fully deductible,"[51] which seems to be the present Canadian situation. This avoids the possibility of option clauses determining the tax treatment of lease arrangements, or the problem of the "dual-potentiality" of rental payments.

The tax implications must be considered, yet the real cost of any financing method cannot be ascertained "... purely on the basis of the tax treatment accorded its elements, although taxation is an important factor in determining over-all cost."[52] Therefore the choice between leasing and other debt forms should be on the basis of the actual cost, and leasing should be selected when its costs are lowest.

Improvements to Leased Land

It often happens that a lessee will decide that improvements are necessary on the leasehold asset to improve its income potential. Although the lessee will never have clear title to the property, he may initiate certain changes or additions to the leased assets. In Canada,

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[50] Canada: Income Tax Act; Section (12), (2). See also H. Heward Stikeman, Income Tax Act RS.C. 1952, C 148 Annotated (Toronto: Richard De Boo Limited, 1967, p. 119.

[51] Cohen, Leases, p. 72.

[52] Ibid., p. 72.

> where a tenant has erected a building on leased land, has made an addition to a leased building, or has made alterations which change the nature or character of the property, he cannot amortize such costs over the term of the lease, but instead is considered to have acquired a capital asset which can only be amortized by means of the normal depreciation charges allowed to all other taxpayers.[53]

Leasehold improvements have been constructed on the air rights above property owned by others. Many hotels, apartments and office buildings located on Park Avenue in New York have been erected on the air rights over the right-of-way owned by the New York Central Railway. The lessee pays the ground owner a rental for the privilege of using his air rights, while the owner, frequently reluctant to sell valuable land, receives a return from otherwise unused property.[54]

In another arrangement, mortgage bond issues have been floated on the strength of a leasehold interest. The issue is secured by the improvements which the lessee owns, yet the property title remains with the landowner-lessor. The lessee will sell mortgage bonds on the strength of the leasehold interest, and the long-term ground lease granted by the lessor. The tenants, who will occupy the leasehold property, guarantee to make sufficient funds available to enable the lessee to meet the commitments under the bond indenture. This rental deficiency agreement secures the bond issue and insures the success of the venture. The lessee's income will be produced from the brokerage activities of collecting rentals and paying bond interest and sinking fund obligations, rather than from the use of the leasehold itself. At least two Canadian companies have used this arrangement

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[53]Arthur W. Gilmour, Income Tax Handbook 1967-1968 (Toronto: Richard De Boo Limited, 1967), 1, 428.

[54]Greenfield and Griesinger, Sale-Leasebacks, p. 26.

recently to develop leaseholds through mortgage bond issues, in which the lease was an integral part of the transaction.[55]

BANKRUPTCY

The problems of the bankrupt tenant have often been suggested by opponents of long-term leasing as a major disadvantage of this type of financing. The investor in financial leases has less security and certainty of return than the investor in mortgage bonds, because of the ramifications of the Act. The most common situation in bankruptcy is the instance of the tenant's insolvency.[56] This leaves the lessor to seek some compensation for his loss under the various sections. The major problems of bankruptcy "... flow from the conflict which occurs between the interests of the landlord and the interests of the trustee."[57]

The pertinent section of the Act which acts upon many accounting decisions concerning the status of long-term leases, is summarized by Houlden and Morawetz:

> The landlord ranks sixth in priority for arrears of rent for a period of three months next preceding the date of assignment or the date of the filing of the petition and for accelerated rent for a period not exceeding three months following the date of assignment

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[55] Wood Gundy Securities Limited, Offering Circulars for Toronto Dominion Center Limited and Woodbine-Sheppard Shopping Center Limited.

[56] L. W. Houlden and C. H. Morawetz, Bankruptcy Law of Canada (Toronto: Carswell Company Limited, 1960), p. 224.

[57] L. W. Houlden, "Bankruptcy of the Landlord or Tenant, " in The Lease in Modern Business, Special Lectures of the Law Society of Upper Canada (Toronto: Richard De Boo Limited, 1965), p. 17.

> in bankruptcy ... if entitled thereto under the lease. However the total amount so payable in priority shall not exceed the realization from the property on the premises under lease: Sec. 95 (1) (f).[58]

The trustee of the bankrupt's estate has various options open to him as prescribed by law, which permit him to settle the lease in the best interests of the bankrupt. He may "... elect to retain for the whole or part of its unexpired term, or to assign, surrender, or disclaim any lease of, or other temporary interest in, any property of the bankrupt."[59]

If no purchaser can be found for the lease or if an assignment of the contract is not possible, then the trustee can serve a notice of disclaimer upon the landlord. As Houlden and Morawetz further explain, the balance of the landlord's claim, above that provided by Sec. 95 (1) (f), will be left to be satisfied as and when funds are available in the bankrupt's estate. "A landlord is not a 'secured creditor' under the Bankruptcy Act, in respect of a claim for arrears of rent."[60]

From the implications of the Bankruptcy Act, it is obvious that the investor in a lease is less secure than an investor in a mortgage bond issue. This may be considered a disadvantage of leasing from an investor's position and can be used in favor of investment in secured instruments. However, Cohen feels that, while there are indeed important differences with respect to the legal rights and security of

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[58] Houlden and Morawetz, Bankruptcy Law, p. 224 (emphasis in original).

[59] Revised Statute of Canada, 1952, Ch. 14, The Bankruptcy Act, Section 10 (1) (k).

[60] Houlden and Morawetz, Bankruptcy Law, p. 224.

these investment opportunities, "... it is doubtful that the possibility of bankruptcy should be considered of primary significance in determining the merit of any long-term investment, since it would seem that the slightest suspicion of the possibility of bankruptcy would make the investment too speculative for the typical institutional investor."[61]

Cohen adds, "... that the earning power of the borrower must be evaluated before the quality of a long-term investment can be appraised."[62] This applies equally well to long-term mortgage debt as it does to long-term leasing. Certainly, this is borne out in practice. The credit of the lessee was picked first by most analysts as the prime factor to consider in weighing an investment in a lease arrangement (See Appendix p. 156).

RESIDUAL VALUES

Conflicting statements are found in reference to the effect of the residual value on the actual cost of lease financing. Vancil summarizes these arguments regarding equipment leasing:

> Exponents of lease financing minimize the significance of residual values by pointing out (1) that the lessee will already have used the equipment for most of its useful life, (2) that the residual value is therefore small, (3) that the lessee may have an option to purchase the equipment at an attractive price or to continue to lease it at reduced rates, and (4) that even in the absence of such an option the lessee can purchase the equipment for its then marked value. Opponents of lease financing on the other hand, stress that the lessee under a financial lease has already paid the full cost of the equipment and that any

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[61] Cohen, Leases, p. 81.

[62] Ibid., p. 80.

> additional payment for the residual value, either for purchase or for an extended lease, is clearly an excess cost of lease financing which could have been avoided by outright purchase.[63]

DISADVANTAGES REVEALED BY QUESTIONNAIRE

The companies employing long-term leases were asked to list the disadvantages which they felt existed in the leasing of fixed assets. Of the several disadvantages indicated, two were mentioned most often. The higher interest rate and the loss of flexibility were considered as negative aspects of long-term leasing. One of the companies surveyed considered the ease of negotiation of a lease as distorting the decision between leasing or borrowing (See Table III).

TABLE III

Disadvantages Reported in Long-Term Leases

	Disadvantages	Companies	
		Number	Percent
1.	Flexibility is lost in leasing.	7	33
2.	Leases have a higher interest rate than other forms of long-term finance.	8	38.
3.	Ease of lease negotiation can distort the decision between lease or borrow.	2	9
4.	Loss of capital appreciation in fixed asset.	3	14
5.	Loss of residual value.	1	6
	Total	21	100

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[63] Vancil, Leasing Industrial Equipment, p. 154.

Although most investors in long-term leases, as indicated by the questionnaire, consider the credit of the lessee to be the most important factor in appraising the investment, the typical lease will have a higher interest rate than that experienced in direct debt forms. Seventy percent of the companies surveyed agreed that the interest rate implicit in financial leases would be higher than bonds or debenture borrowing. The companies also indicated that the interest charged under a lease was very important in their decision to lease. Forty-four percent gave considerable attention to the rate, while fifty-three percent considered it as an important factor to be weighed in an overall appraisal. Gant suggests the premium expected by the lessor will be in the range of 1/2 of 1% to 1% or greater.[64]

SUMMARY

To generalize from this discussion, it is possible to suggest that the comparative advantage of lease financing over other methods is essentially subjective. In some circumstances the decision to lease may be made because of necessity, where leasing provides the only means available of acquiring an asset. Sometimes avoidance of various lending restrictions can be achieved through leasing rather than borrowing, but these are more likely to be peculiarities rather than advantages. Overall, there seems to be very little difference between leasing and borrowing, and many of the supposed leasing advantages are illusory. In fact, in many cases financing through long-term leases is not as

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[64] Gant, "Lease Financing," p. 126.

economically sound as financing by long-term debt, especially when the lessee experiences a higher interest charge and loses the residual value of the asset at maturity. However, lease financing is one method of acquiring fixed assets, and it must be considered a major source of long-term borrowing.

Notwithstanding the weaknesses of leasing, seventy-five percent of the company replies suggested that it should continue to strengthen and become a more important financing tool. As well, there is evidence of a growing awareness among financial analysts of the significance of lease commitments in appraising a company's financial position. Although present accounting deficiencies exist in Canada, which permit the off-balance sheet disclosure of long-term leases, it is hoped that this "advantage" will be removed when the accounting and reporting practices attain the level of the disclosure obviously needed by users of financial statements. This improvement in financial reporting must come if leasing expands as a financing tool, and when the nature of the lease is better understood in the financial community.

Chapter IV

FINANCIAL STATEMENT DISCLOSURE OF LONG-TERM LEASES

Introduction

The previous chapter considered many of the institutional factors affecting long-term leases. The essential point of Chapter Three was that leasing must be considered as a method of long-term financing. Many of the advantages suggested for leasing are illusory, and the lease's basic nature is only revealed upon a closer, objective examination. It is a method of securing fixed assets, and in many ways it is similar to conventional debt forms.

The financial reports of companies employing long-term leases, however, do not always recognize the importance of lease financing. Rather than include any leased asset or liability amount in the balance sheet, the companies are content to relegate the long-term lease disclosure to a general footnote. Although there is a growing recognition of the importance of these property rights and related obligations by financial analysts, the accounting profession in Canada has done little to improve this information deficiency in published financial statements. It is suggested, therefore, that footnote disclosure of long-term leases is an inadequate and incomplete method of reporting long-term leases.

If long-term leasing is to be considered as a form of selected borrowing, then financial statements could be enhanced by the inclusion of an asset and liability amount in an entity's financial position statement. While it is unconventional to reflect an amount in a company's balance sheet which is not evaluated on some objective basis,

such as cost, it is possible to measure the property rights under a lease and include these items in the financial statements. The capitalization of the future amounts of annual rental payments over the term of the lease, at some rate, is one measure of the present value of the property rights received by the lessee.

If the capitalization process is to be considered as more than just a pretentious device designed to complicate accounting procedures, then the resulting property rights and obligations must satisfy the currently accepted accounting interpretation of assets and liabilities. This chapter will consider the capitalization process and the related problems in a general discussion considering the nature of the asset and the liability amount under a lease. The service potential notion, as the essential element in an asset, will be considered. The suggestion being that if enough objective evidence can be presented to substantiate the use of the discounted cash flow as a measure of an asset service potential, then the item can be included in the balance sheet as an asset. It is hoped that the capitalization of lease payments can be shown to be a viable accounting approach to long-term lease reporting, which will improve financial statement disclosure.

Naturally there are many issues which must be considered before capitalization can be accepted. These include: the discount rate to be applied to the stream of payments; the amortization of asset amounts and the income determination process; and the contention that only owned assets (as opposed to leased) should be included in an entity's financial statements. These problems and those experienced in accounting for the liability under the lease will be reviewed here. An example of the

accounting approach to capitalization of long-term leases will be examined. Where pertinent, the results of the questionnaires will be included.

Current Lease Disclosure Practices

The Case Against Capitalization

Those who support footnotes as the only method of disclosure of long-term lease commitments consider the defects in title to have a very important bearing on the lease arrangement. This legal argument suggests that since no title has passed, the lessee should not claim any equity in the asset. Therefore, the asset evolving from a lease cannot be properly included in the entity's balance sheet except to the extent of an attached footnote. By using this off-balance sheet disclosure, the company is not properly disclosing all relevant information regarding the financial resources for which management is responsible. It is therefore difficult to appraise the effects of a lease on a company's financial position in so far as rates of return on assets employed to earn income are concerned.

Conventional accounting procedures, certainly in Canada and to some extent in the United States, have perpetuated the fundamental proposition of asset ownership as the requisite for balance sheet inclusion. However, exceptions to this principle are sometimes encountered. In the case of an agreement for sale, for example, the asset and liability amounts are reflected directly on the balance sheet, notwithstanding that title will pass only when the purchaser has satisfied the liability owed to the vendor.

Further, the Canadian Income Tax Regulations[1] specify that when an expenditure is made to improve leased premises, particularly a building, the lessee is deemed to have acquired a capital asset. This cost must be written off by annual depreciation charges in the same manner as any other fixed asset. Other minor improvements to leased premises may be written off over a five-year period or over the term of the lease, but are considered as depreciable fixed assets as well.

The point is that in neither case did title technically pass to the user of the assets, yet in both instances the respective amounts would be included among a company's assets and liabilities without question. The departure from the ownership criteria for balance sheet inclusion is thus supported in practice as well as by government legislation, which specifically suggests a method of accounting for material leasehold improvements. This is one instance, unfortunately, in which the tax practice has led in the transition in practical financial statement disclosure.

While the failure in title has been the most often cited reason for footnote disclosure over balance sheet inclusion of the lease commitments, Myers summarizes several other common objections to direct reporting: (1) capitalization is too subjective, and the statements will be made meaningless; (2) capitalization will upset basic accounting conventions, which could evoke serious economic consequences in financial ratios or rate making ratios; and (3) illusory reporting practices will

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[1] Canada: Income Tax Regulations (14th ed.; Toronto: CCH Canada Limited, 1958), Part XI, Section 1102, subsections (4) and (5).

be lost in capitalization.[2]

The substance of these objections is very thin. While capitalization does require some subjective judgement, the improved financial statement disclosure of the assets and liabilities employed by the entity, together with the resulting adjustments to important analytical ratios, will more than outweigh any subjectivity which may occur. Estimates are widely used in accounting practice today, for example in depreciation policies[3] and capitalization of the property rights and the related obligations will involve little more. In the interests of improved financial statement disclosure the accounting standards must evolve and new reporting methods explored, to better classify business activities, especially during periods of rapid environmental change. In so far as the loss of the reporting advantage of off-balance sheet disclosure is concerned, it represents fallacious reasoning. There must be continued efforts to update financial statement disclosure, and this responsibility rests with the accounting professions. As Cohen observes, "to the extent that current accounting principles have permitted the exclusion from financial statements of assets held under long-term leases and the accompanying obligation to make payments in the form of future rentals, the accounting profession may be held partially at fault for nourishing this somewhat narrow philosphy."[4]

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[2] John H. Myers, "Reporting of Leases in Financial Statements," Accounting Research Study No. 4, (New York: American Institute of Certified Public Accountants, 1962), pp. 7-8.

[3] Ibid., p. 7.

[4] Albert H. Cohen, Long-Term Leases, Michigan Business Studies, Vol. XI, No. 5 (Ann Arbor: University of Michigan Press, 1954), p. 111.

There are the important objections to the inclusion of capitalized values under a long-term lease in the balance sheet. From a review of the published financial statements of many large corporations, it appears that footnotes are currently the accepted method of disclosure by the majority of the firms in the United Sates and by all the firms in Canada. To appraise the adequacy of this disclosure approach, the reporting practices in the United States and Canada will be reviewed. The United States practice is important since much of the theory and practical progress in long-term lease reporting has been recorded there. Some of the financial statements of Canadian corporations will be examined to provide an insight into the current reporting problems of lease financing arrangements.

American Accounting Practice for Long-Term Leases

The AICPA Accounting Principles Board in Opinion No. 5,[5] has considered the problems of long-term lease reporting and has recognized two general types of long-term leases: (1) right to use leases, and (2) purchase equivalents. Their method of presentation in the case of right to use leases requires disclosure rather than capitalization as the suggested accounting treatment of these leases. Those leases which are purchase equivalents should be recorded as asset acquisitions, and the property and the obligation should be stated in the balance sheet at an appropriate amount of future payments under the lease agreement. The American practice has recognized the importance of improved

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[5] Accounting Principles Board, "Reporting of leases in Financial Statements of Lessee," Opinion No. 5 (New York: American Institute of Certified Public Accountants, 1964), p. 32.

disclosure of long-term leases, and has recommended the capitalization approach at least for purchase equivalent leases.

Canadian Accounting Practice for Long-Term Leases

The Canadian Institute of Chartered Accountants only requires a footnote disclosure of the relevant information on long-term lease commitments. Long-term leases are generally considered to be "Contractual Obligations" by the accounting bulletin, which suggests that:

> Notes to financial statements are useful for purpose of clarification or further explanation of the nature of items in the financial statements. As such, they have the same significance as if the information or explanations were set forth in the body of the statement.[6]

The Canadian bulletin does not provide for the capitalization of any property right under a lease, nor is there any attempt to differentiate between the possible types of long-term leases such as purchase equivalents or right to use leases.

Before examining some of the Canadian companies who reflect lease information in footnotes to their balance sheets it may be helpful to review the lease details expected to be contained in a footnote, as indicated by Bulletin 20.

> ... disclosure of the type of property leased, the maturity date or dates, particulars of renewal clauses or options at maturity, the amount of rental paid during the current period ... the amounts of minimum annual rental to be paid under such leases ... In the year in which the transaction is effected, the principal details of any sale and leaseback transactions, including the disposition of any gain or loss on the transaction ...[7]

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[6]Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, "Bulletin No. 20, Standards of Disclosure in Financial Statements," Accounting and Auditing Practice (Toronto: Canadian Institute of Chartered Accountants, 1964), p. 10.

[7]*Ibid.*, pp. 9-10.

In reviewing the various published financial statements, it would appear that Canadian companies are including more lease information in their footnotes each year. Several companies disclosing long-term leases are following the suggested practice of Bulletin 20, yet there are many whose footnotes do not even achieve the level suggested adequate by these Canadian disclosure standards.

Loblaw Groceterias Co., Limited gives a good footnote disclosure of relevant lease information by providing a schedule of aggregate lease commitments for the reader:[8]

> Long-term leases.
> The aggregate minimum rentals (exclusive of taxes or insurance, and other occupancy charges to be paid by the Company and its subsidiaries) under long-term leases (extending beyond five years from the balance sheet date) in effect June 3, 1967, are as follows for each of the periods shown:

1968-1972	$150,712,000
1973-1977	116,454,000
1978-1982	68,674,000
1983-1987	33,392,000
1988-1992	13,498,000
After 1992	9,187,000
	$391,917,000

Loblaws follows the recommendation of Bulletin 20 regarding sale and leaseback disclosure. The method of accounting for the gain on the sale of fixed assets under a sale and leaseback is presented, together with information as to the current year's profit on these transactions. There is little doubt that the amount of outstanding commitments, as well as the property rights involved, are material in the complete appraisal of the firm's operation.

[8] Loblaw Groceterias Co., Limited, Annual Report 1967.

Revenue Properties Limited also provides a good presentation in so far as footnote disclosure is concerned:[9]

> Lease Obligations.
> Subsidiaries have sold and leased back certain properties and annual rental income from such properties is approximately equal to annual rents payable. Rents paid during the year on properties sold and leased back amounted to $1,838,750.
> The subsidiaries have the right to terminate certain of the leases upon payment of a specific amount relative to each such lease with the aggregate amount of such payments being $1,792,650. The following sets out the annual rents payable under leases in effect at December 31, 1967, and the annual amount of rent that would be payable if the subsidiaries exercised their rights to terminate leases.

Year	Approximate Annual Rents Payable	Approximate annual Rents Payable if subsidiaries exercised rights to terminate leases
1968	$2,782,000	$882,000
1969	2,525,000	625,000
1970	2,313,000	414,000
1971-1976	2,138,000	238,000
1977-1978	2,107,000	207,000
1979	2,034,000	187,000
1980	1,711,000	-
1981	1,552,000	-
1982-1987	1,388,000	-
1988-1989	502,000	-
1990-1997	409,000	-

> Rents are paid on long-term land leases approximately as follows:

1968	188,000
1969-1993	166,000
1994-2019	154,000
2020-2060	133,000

Some companies use a highlighting technique on the face of the balance sheet to direct the reader to the applicable footnote on lease

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[9] Revenue Properties Ltd., Annual Report 1967.

commitments. The highlight would occur on the balance sheet in a conspicuous location, often below the long-term liabilities. Pacific Western Airlines Limited has a reference to outstanding lease obligations under the liability and equity section.[10] Robinson Little and Co., Limited discloses the lease footnote directly on the face of the balance sheet, below the fixed asset section:

> Note-Lease Commitment.
>
> The company's warehouses are leased at an annual rental of $63,000 under an agreement expiring April 30, 1990, with options to renew for a further fifteen years at a reduced rental.[11]

The reader is thus alerted to the presence of these lease commitments and can attempt to appraise their impact on the company's financial position.

Not all companies comply with the minimum standards of disclosure. Zeller's Limited ignores most of the recommendations of the bulletin in their disclosure. There is no reference to the relevant footnote, nor would it be possible to determine the implications of the lease commitments on the company's overall financial position from the information provided.

> Minimum annual rentals under long-term leases, the longest of which will expire in 1992, amount to approximately $4,300,000.[12]

There is no indication of (1) the type of property leased; (2) the details of renewal clauses or options at maturity; (3) the exact

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[10] Pacific Western Airlines Limited, Annual Report 1967.

[11] Robinson, Little and Co., Limited, Annual Report 1965.

[12] Zeller's Limited, Annual Report 1967.

expiration date of the leases; or (4) the exact amount of annual rentals payable under each lease. The company's total secured debt, in the form of sinking fund debentures, is $12,423,000 and it would appear that the aggregate long-term lease commitments would exceed this amount. Thus there is little question that this financial report falls short in providing adequate information for the reader.

Several companies, for example Simpsons Limited,[13] disclose the lease information in the footnote under the caption "Commitments and Contingent Liabilities." This creates the impression that lease commitments and contingent liabilities are the same. This is not the case however. The lease commitments refer to contractual obligations which must be fulfilled by a firm to continue to have the use of an asset. A contingent liability may or may not involve a direct outlay of funds by the company. Most companies, however, do recognize the difference and separate contractual obligations from the contingent liabilities for purposes of disclosure.

The Case Against Footnotes

The information reported by most companies is of limited value. The details provided by the footnote are not adequate, and the reader is forced to make arbitrary assumptions to appraise the impact of the lease on the company's position. The assumptions may often work to the disadvantage of the entity involved.

The Committee on Auditing and Accounting Research indicates that it believes that the information contained in a footnote has "... the same significance as if the information or explanations were

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[13] Simpsons Limited, Annual Report 1967.

set forth in the body of the statements."[14] This is a contentious statement, particularly with respect to long-term leases. If the future lease payments are discounted to the present value and capitalized on the balance sheet, then the footnote form is ideal for the purpose of clarification or further explanation of the nature of items presented in the financial statements. However, the footnote cannot properly account for long-term leases, when in fact the information contained in most footnotes is below that proposed by the Committee.[15] As it is, many firms are likely to provide the minimum amount of information possible, not only in leasing matters but also in other reporting areas. This problem is compounded by footnote disclosure.

The Canadian Institute of Chartered Accountants, in their continuing study of 325 Canadian firms, sets out the extent of lease disclosure of these companies as reflected by their annual reports.[16] The eight points of disclosure are the minimum suggested by the Committee on Accounting and Auditing Research. In 1966 there were 101 companies making reference to long-term leases, of which 82 actually gave the details of these contracts. This schedule shows to what extent those 82 companies followed the recommendations of Bulletin No. 20.

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[14] Committee on Accounting and Auditing Research, Bulletin No. 20, p. 10.

[15] Canadian Institute of Chartered Accountants, Financial Reporting in Canada, Seventh Edition 1967 (Toronto: Canadian Institute of Chartered Accountants, 1967), p. 62.

[16] *Ibid.*, p. 62.

	1966	1965	1964	1963
Amount of minimum annual rental	72	56	45	34
Type of property leased	48	46	26	22
Maturity date of leases	39	27	18	16
Amount of aggregate rental	21	20	14	14
Term of lease	21	19	14	14
Renewal clauses or options at maturity	9	6	3	2
Existence of special features	8	7	8	5
Principal details of sale and lease-back transactions in year in which transaction is effected	1	2	-	1

Source: The Canadian Institute of Chartered Accountants, Financial Reporting in Canada, Seventh Edition 1967 (Toronto: Canadian Institute of Chartered Accountants, 1967), p. 62.

It may be fair to conclude, from the companies surveyed and reported in the above schedule, that their footnote disclosure does not provide enough information regarding long-term lease commitments. The Canadian practice is indeed inadequate and there are many cases where the information considered desirable by the Committee is not being provided. If a direct reporting practice, such as capitalization of future lease payments was required, at least the reader would be able to determine the related property rights under a lease. It is doubtful if capitalization is possible, even as an analytical device in very many of these Canadian firms. These results cast serious doubt on the Committee's suggestion that footnote disclosure is comparable to direct reporting.

The practicing accountants refuse to change their reporting approach to long-term leases, even when the evidence shows that the information contained in the footnotes is inadequate. As Cohen notes:

> Probably the primary reason for the accountants tendency to relegate disclosure of long-term leases and their details to footnotes lies in the unwillingness to depart from an accounting treatment which is

> based almost exclusively upon the strictly legal relationships established in the leasing transaction.[17]

The legal argument was discussed above as a major shortcoming in the balance sheet. However if the users of financial statements are to assume, with any confidence, that the information contained in the statements is objective and impartial, then better reporting practices will have to be established. In fact by basing the method of disclosure on the ownership criteria and by placing long-term lease information in footnotes entirely, the financial statements are not distinguishing the substance of the leasing transaction but merely the legal status of the parties. Spacek regards this failure to reflect long-term leases in the financial statements as "... another illustration of adherence to technical details and outmoded practices within the profession in its failure to recognize the corporate obligations imposed by long-term leases."[18] Spacek also considers the footnote as an inadequate means of disclosing important lease information:

> Footnotes are an inadequate substitute for the proper recording of a long-term lease obligation properly discounted to today's value. Footnotes that set forth annual rentals expiring in various years in the future leave the job incomplete. This is like hiring a contractor to build a house and have him declare the job done when he has dumped the necessary raw materials of lumber, stone, plaster, windows, etc. at the site.[19]

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[17] Cohen, Leases, p. 115.

[18] Leonard Spacek, "Can We Define Generally Accepted Accounting Principles?" Journal of Accountancy (December, 1958), p. 46.

[19] Leonard Spacek, "Letters to the Editor," Harvard Business Review (July-August, 1959), p. 174.

If the financial position statement is to furnish a measure of the entity's resources,[20] or unused services,[21] then the property rights acquired under a long-term lease should be reported directly on the balance sheet. Spacek observes that "there is no more reason to omit this asset and the corresponding liability in the case of a long-term lease than there is to omit both the plant and the debt when the plant is financed by borrowed income."[22] It is clear that the footnote disclosure is not an adequate method of presenting information on financial leases.

Nelson conducted a study on the impact of leases on the financial analysis of 222 United States corporations, and found that very few provided sufficient information on long-term leases to enable the user to capitalize the leases accurately. Of his sample, only eleven companies could finally be selected for capitalization studies:

> ... none of the companies provided all of the details required for precise computations. This reduced the possible scope of the study by introducing certain assumptions and estimates into the calculations. For example, in only one instance was the exact lease expiration date shown. In all other cases, the reader was told only that a large number of leases were to expire within a specified period of time (usually five to ten years). Likewise, the annual rentals payable under each individual lease were often buried in aggregate figures. Even more significant, however, was the omission of the interest rate implicit in each

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[20] Committee on Concepts and Standards, American Accounting Association, "Accounting for Land, Buildings, and Equipment, Supplementary Statement No. 1," <u>The Accounting Review</u> (July, 1964), p. 694.

[21] Eldon S. Hendriksen, <u>Accounting Theory</u> (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 198.

[22] Spacek, "Accounting Principles," p. 47.

> of the lease agreements. None of the companies gave any indication of this implied interest rate in its annual report ...[23]

A similar conclusion can be reached with respect to published statements of Canadian corporations.

Myers has recommended that footnotes by used solely as a means of providing additional information and details on leases contracted by the company. Myers is an advocate of the capitalization method of disclosure and proposes that all long-term, noncancellable leases should be reflected directly on the balance sheet. Thus footnotes would play a secondary role as a method of reporting.

> The function of notes, however, should be to supplement (namely, to give elaborate details on) the items already presented in the statements rather than to complement (complete) the statements themselves. If notes are used only to supplement, the balance sheet itself will give a complete summary of the financial position.[24]

Questionnaires

While the theoretical arguments may favor capitalization as the better method of disclosing long-term leases the practitioners favor footnote disclosure. The companies using long-term leases and the financial analysts as well, were asked if they favored the formal capitalization of the discounted annual lease payments as a standard method of disclosure. Approximately thirty percent of the replies favored capitalization. A breakdown of the reasons for the opinions is provided in Table IV.

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[23] A. Tom Nelson, The Impact of Leases on Financial Anslysis, Michigan State University Bureau of Business and Economic Research, Occasional Paper No. 10 (East Lansing, Michigan: Graduate School of Business Administration, 1963), p. 69-70.

[24] Myers, Accounting Research Study No. 4, p. 4.

Table IV

Formal Capitalization of Long-Term Leases for Disclosure

		Yes	Some-times	No	Total
1.	Are you in favor of capitalization as a standard method of long-term lease disclosure				
(a)	Number of Analysts replying	6	6	16	28
(b)	Number of Companies Replying	8	2	11	21
	Total	14	8	27	49
	Percent of total replying to the question	29%	16%	55%	

		No. of Mentions
2.	Reasons provided for replies	
	Reasons in favor of capitalization	
(a)	better comparisons are possible between companies	5
(b)	more consistent method	2
(c)	the legal argument of title is important, but disclosure is more important	
(d)	should be capitalized if an equity is created in the asset	1
(e)	more attention directed to the respective asset and liability amounts and less estimation of capitalized amounts	2
(f)	leasing is a form of debt and should be disclosed as such	4
	Reasons against capitalization	
(a)	footnote disclosure is adequate	14
(b)	capitalization involves many subjective decisions	7
(c)	the lessee does not own the assets ("a lease is a lease")	1
(d)	the important advantage of off-balance sheet disclosure is lost	1
(e)	assets and liabilities of the entity would be over-stated	1
	Reasons for some possibility	
(a)	when the lease is in substance a purchase of the asset	6

A Review

The AICPA Accounting Principles Board separates long-term leases into two categories, purchase equivalents and right to use leases. The suggested accounting practice for purchase equivalents is the capitalization of the future rental payments at some rate. The Canadian Committee on Accounting and Auditing Research advocates footnote disclosure entirely, but in practice the Committee's recommendations are ignored by most companies disclosing long-term leases. Many authorities on accounting standards believe that footnote disclosure is an inadequate method of disclosing these material asset and liability amounts. With the normative arguments suggesting capitalization as a preferable approach and showing footnotes to be inadequate, Canadian accounting practice should change to remedy these current disclosure deficiencies.

If capitalization is the solution to the reporting problems of long-term leases confronting the accounting profession, there should be sufficient support to substantiate the claim that an asset and a liability is created by a long-term lease. The next section of the chapter will be a discussion of the merits of the capitalization process, together with the related problems of reporting and measurement.

THE CAPITALIZATION PROCESS

The Asset Value of the Leased Rights

The common argument against capitalization of the discounted future rentals under a long-term lease has been the ownership deficiency. Since title has not passed, it is argued the lessee does not have an equity in the asset under the lease, and thus the inclusion of any amount in the balance sheet would be a serious mis-statement of the company's financial position. Hendriksen discussed two other major problems which are critical to the capitalization decision: "... (1) the difficulty in separating that portion of the rentals considered to be payment for property rights and that considered to be payment for services yet to be performed; and (2) the selection of the proper rate of interest for capitalization."[25] These latter two problems will be discussed in this section. As well, consideration will be given to the issue of whether or not an asset and a liability amount is transferred or created under a long-term, noncancellable lease. Does the right to the uninterrupted use of the leased asset provide the lessee with an economic benefit which would justify the inclusion of a property value on the balance sheet? Support can be provided for the premises of capitalization and the direct balance sheet disclosure of leases, under the service potential notion of assets.

Interpretations of Assets

As accounting theory has evolved, so has the general understanding of many of its terms and concepts. Most authors have their own definition

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[25]Hendriksen, Accounting Theory, p. 383.

of an asset, which is developed through a discussion of the relevant accounting processes. By reviewing several important sources of accounting theory, a basic understanding of the concept of assets, as applied to ordinary assets, can be achieved. It is possible that the current concept of assets may justify the inclusion on the balance sheet of the leased property rights received, under this penumbra of asset understanding and interpretation.

Paton presented an early definition: "an asset may be broadly defined as any consideration, material or otherwise, owned by a specific business enterprise and of value to that enterprise."[26] In this descriptive definition, Paton has embodied the traditional accounting conservatism of ownership as a prerequisite to inclusion of an item in the asset category. As Vatter observed, the definition does not specify the things that must be done to establish the presence or the absence of an asset, and it does not clearly mark out what costs are to be applied in distinguishing assets from other things.[27] This definition makes no attempt to include such items as mortgaged property or deferred charges for leasehold improvements. In this sense, the definition is not operational but descriptive. It does not cover many of the special items commonly considered to be assets.

Later, Paton remedied some of the inadequacies of the early definition: "An asset may be broadly defined as any consideration, material or otherwise, which is owned by a specific business enterprise

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[26] W.A. Paton, Accounting (New York: MacMillan and Co., 1926) p. 28, (emphasis added).

[27] William J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports (Chicago: University of Chicago Press, 1947), p. 14.

(or in which the enterprise has an equitable interest) and which has a value to that enterprise."[28] The italicized section is added, presumably, to accommodate such assets as deferred expenses or accrued income. By expanding the definition to recognize those assets "in which the enterprise has an equitable interest" Paton has moulded his definition to suit the accounting practice, in an attempt to describe more adequately the characteristics common to all assets.

The departure from the ownership standard, and the development of an interpretation which considered the essence of the economic benefits derived from the service of an asset, was presented by Canning. He suggested that the service element of an item was more important a reason to record a particular charge as an asset than was the ownership criteria.

> What is essential is that there must be some anticipated, identifiable, separate (or separable) service (or income) to be had by a proprietor as a matter of legal or equitable right from some person or object, though not necessarily from an ascertainable person(s) or object(s).[29]

The point of Canning's argument, while recognizing the imperfections of the legal-ownership criteria, introducesthe service element of the asset which pervades much of the current interpretation of the nature of assets. Vatter continues:

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[28]W. A. Paton, Essentials of Accounting (New York: Macmillan and Co., 1938), p. 23, (emphasis added).

[29]John B. Canning, The Economics of Accountancy (New York: Ronala Press Company, 1929), p. 14.

> Assets are economic in nature, they are embodiments of future want satisfaction in the form of service potentials that may be transformed, exchanged, or stored against future events. Whatever means or method is employed to measure assets (cost, price, appraisal, or arbitrary valuation), assets are service potentials not physical things, legal rights, or money claims.[30]

More of the recent definitions of assets have embraced the service potential notion, which transcends owership restrictions and considers the economic benefits accruing to the entity. The American Accounting Association defines assets as:

> ...economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service potentials available for, or beneficial to, expected operations. The notion of service potentials provides a sound conceptual basis for asset valuation.[31]

Chambers defines an asset as "...any severable means in the possession of an entity."[32] He defines severable means as "...any means which, at any given time of action, may be converted to other means of exchange or the processes of production."[33] Vatter also suggests that the conversion process is basic to the nature of assets: "...wants are satisfied by the conversion or transformation of services released from (rendered by) economic agencies, such as persons or things."[34]

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[30]Vatter, Fund Theory, p. 17.

[31]American Accounting Association, "Accounting For Land, Buildings, and Equipment," p. 694.

[32]Raymond J. Chambers, Accounting, Evaluation and Economic Behaviour (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1966) p. 103.

[33]Ibid., pp. 103-104.

[34]Vatter, Fund Theory, p. 16.

The right of these future conversions which accrue to the firm is the asset value, and these rights are available for subsequent business operations. The claim to these conversions must be specific, and the rights must embody a positive, potential benefit for the firm.

The lease rights under the service concept can be considered as an accumulation of potential services to be released or converted to the benefit of the lessee over the term of the lease. If these service conversions can be measured as they relate to the generation of income for the business, then an asset value exists under a long-term lease. Since the lessee has the right to the complete use of the asset over the lease term, an aggregate of service potentials has been acquired.

> The lessee's right to use the property is a claim on service-potentials available for his future operations, acquired at a cost represented by the obligation to pay rents. The reason for accounting for the assets and obligations in a lease-contract is not that the lease is equivalent to a deferred payment sale, but that there has been a transfer of property rights, together with a financing arrangement.[35]

The asset definition in terms of service potentials was also developed by Myers, who refers to the "user-rights" of the asset:

> The service receivable in the present case of leases is the right to use of the property. The asset, right to use leased property, is truly an asset even though not owned. The lessee has a service receivable from the leased asset. To the extent the lessor has performed his full duties, the asset should be recognized. This is the common case in the net lease.[36]

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[35]William J. Vatter, "Accounting for Leases," The Journal of Accounting Research, Vol. IV, No. 2 (Autumn, 1966), p. 135.

[36]Myers, Research Study No. 4, p. 40.

The method of determining the asset value and the related liability are examined later in this chapter. It is sufficient to state that the asset value which should be shown on the balance sheet will be the discounted future rentals, which constitute the value of the property right received.

Liabilities Under the Lease

If there is a service potential in the user's right to a leased asset, which in essence provides the lessee with an asset for inclusion in the balance sheet, is there any similarity between the obligation to pay annual rentals under the lease contract and other liabilities within the currently accepted accounting practice? Chapter Three outlined the similarities between long-term debt and long-term leases. Aside from the problems arising out of bankruptcy, these financing schemes are very much alike. In this section the accounting definitions pertaining to liabilities will be examined to reinforce the contention that contractual obligations under a long-term lease should be included as a liability for balance sheet disclosure.

Kohler defines a liability as:

> An amount owing by one person (a debtor) to another (a creditor), payable in money, or in goods or services: the consequences of an asset or service received or a loss incurred; particularly, any debt (a) due or past due (current liability), (b) due at a specified time in the future (e.g., funded debt, accrued liability), or (c) due only on failure to perform a future act (deferred income; contingent liability).[37]

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[37]Eric L. Kohler, <u>A Dictionary for Accountants</u> (New York: Prentice-Hall, 1952), p. 46.

The liability can arise as a result of "an asset or service received" and thus the obligation under a lease could be included in this definition. Accounting Research Study No. 3 considers liabilities as obligations which are: "...a claim or a series of claims against the business enterprise, each of which has a known or reasonably determined maturity date and an independent value which is known or reasonably measured."[38]

The accounting practice regarding liabilities is to consider these obligations synonomous with debt, the legal term for an amount owing. By definition, a debt is "...an obligation to pay a fixed sum of money on a definite determinable data (with the right to enforce payment by some appropriate legal remedy)."[39] A lease contract provides the enforceable instrument, and the annual payment required over the term of the lease is the obligation to pay a fixed sum of money. The accounting elements present in a lease contract, which arise out of the transaction, must be those of assets and liabilities. By considering the essence of the lease arrangement, the entity's obligation to pay the fixed, periodic rentals reveals a long-term financing plan.

The lease is a complete transaction, and the relations established by the contract are positive and specific. Even though certain acts are unperformed, the arrangement is incomplete only in the

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[38]Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprise," Accounting Research Study No. 3 (New York: American Institute of Certified Public Accountants, 1962), p. 37.

[39]Maurice Moonitz, "The Changing Concept of Liabilities," in Stephen A. Zeff and Thomas F. Keller, eds., Financial Accounting Theory (New York: McGraw-Hill Book Company, 1964), p. 251.

sense that it involves a future period of time. No special event or action is required to make the arrangement effective, nor is there any cancellation by offset or termination by conditional events. The obligations created by the contract are definite, with all the attributes of liabilities, including legal enforcement. The lessor has completed his part of the agreement by providing the asset. It can be assumed that both parties to the lease will continue to hold to the terms of the contract, and thus the lessee has incurred a liability which he is obliged to pay. Therefore the presentation of long-term lease obligation is direct liabilities on the balance sheet can be supported.

The property rights and the related obligation to pay annual rentals under a long-term, noncancellable lease are very similar in nature to assets and liabilities respectively. This study has reviewed leases in general by considering their basic nature. Opinion No. 5 and Accounting Research Study No. 4 considered two different accounting approaches for long-term leases: the Board separated all leases into two types with a different accounting treatment for each, while Myers capitalized all long-term, noncancellable leases. A brief review of these two proposals will introduce the accounting problems of capitalization which follows.

Opinion No. 5 and Accounting Research Study No. 4

Opinion No. 5 evolved from the research undertaken by Myers on the problem of whether or not an asset and liability is created under right to use leases. It was Myer's recommendation that the

principal payments under all noncancellable, long-term leases should be capitalized. "The present value of contracted lease payments should be placed among the assets and liabilities on a balance sheet to the extent that they represent the right to use property."[40]

The Accounting Principles Board denies that there is any asset or liability amount attached to the right to use property under a long-term, noncancellable lease contract. They consider the rights and obligations relate to unperformed portions of executory contracts and are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. They suggest this is largely because there is no equity in the property accruing to the lessee, and the information pertinent to a right to use lease can be conveyed adequately in a foot note to the balance sheet.[41]

However, the Opinion considers that if the lease is in substance an installment purchase of the property, then the property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. The decision to capitalize the lease amounts as installment purchases of property requires that the terms of the lease result in the creation of a material equity in the property by the lease. The two following conditions generally establish whether or not the lease is a purchase equivalent:

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[40] Myers, Accounting Research Study No. 4, p. 35.

[41] Accounting Principles Board, Opinion No. 5, p. 30.

(a) The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or

(b) The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.[42]

There are also several special circumstances which indicate that the lease is essentially a purchase of property whereby the lessee establishes an equity in the asset, including: (1) special arrangements between the lessee and the lessor whereby the contract is nothing more than a special loan; and (2) the relationship between the lessee and the lessor, such as parent-subsidiary or common directorates.

The Board has provided an extensive enumeration of those leases which should be capitalized. The list encompasses most real property leases, with personal property leases forming the majority of the class of right to use leases which are not suggested for capitalization. It seems, also, that by providing a detailed list of purchase equivalent leases the Board has clouded the distinction between the two categories, since a certain amount of overlap from one category to the next is evident. The importance of capitalization as a method of disclosure receives more emphasis by the Board in this Opinion.

Spacek, who agrees with Myers' proposal for capitalization, dissented from the principal conclusion of Opinion No. 5 and urged that

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[42] Ibid., p. 30.

the present value of all material amounts payable under noncancellable leases should be recorded as liabilities. Spacek concurs with Vatter's proposition that the lease liability is a claim on all other corporate assets ahead of investor's equity and as such should be shown on the face of the balance sheet.[43]

ACCOUNTING FOR LONG-TERM LEASES

Problems of Capitalization

Discounted Cash Flow

If the capitalization process is to become more acceptable as a means of accounting for fixed assets acquired under a long-term lease, then the mechanics of capitalization must be understood. The capitalization of lease rights need not involve a complex mathematical process, but it does require a basic understanding of present value calculations relating to future, periodic payments. The value of the acquired asset under capitalization is determined on the basis of the adjusted money cost of the item (present value) and not on the total cash outlay. The use of the discounted cash flow as an approach to asset valuation has been thwarted by the accounting profession over the years, suggests Parker. Rather than apply discounted cash flow criteria to non-financial investments, the accountants "...naturally turned either to rates of return based on the traditional financial

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[43]*Ibid.*, p. 34.

statements or to such simple and conservative techniques as the payback period.[44] Thus the discounted cash flow method of asset valuation for financial statements has been generally avoided by the accounting profession.

The present value method of asset valuation has been criticised on a procedural basis, since the capitalization process involves some subjective decisions, including: (1) the rate of interest to apply to the stream of rental payments to discount them to a present value; (2) the effect of renewal options on the discounting period; (3) the breakdown of rental payments between principal and service costs; (4) the methods of accounting for the amortization of the asset; and (5) the method of reducing the lease liability by the periodic rental payments.

Although AICPA Opinion No. 5 suggests that purchase equivalent leases should be shown on the balance sheet at an appropriate discounted amount of future rental payments under the lease agreement, there is little to indicate the proper method of discounting the lease payments.[45] This may be an assumption that discounting methods are commonly understood by all practicing accountants. It may be suggested, however, that the accountant, faced with the problem of deciding whether or not a particular lease should be reflected on the balance sheet, may decide in favor of the footnote regardless of the circumstances, if only to

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[44]R. H. Parker, "Discounted Cash Flow in Historical Perspective," Journal of Accounting Research (Spring, 1968), p. 70.

[45]Accounting Principles Board, Opinion No. 5, p. 32.

avoid the discounting calculations required. This poor understanding of the mechanics of discounting to which Parker refers,[46] may account for some of the inadequate accounting practices for lease contracts and even for the lack of information disclosed in footnotes. A large amount of the inaccurate criticism of the capitalization approach to balance sheet disclosure may be based on the imprecise notions of capitalization held by many accountants.

Selection of the Interest Rate for Capitalization

The interest rate suggested for use in discounting the future payments under a lease is that rate used in setting the rentals. The use of the interest rate implicit in the lease itself has received the widest support from accounting authorities and would seem to be the best measure to employ.[47] This rate can usually be substantiated from the lease contract, and in many instances it may have been the issue in negotiation, for example this is typical of a scale and lesseback transaction.[48] The replies received from the analyst questionnaire substantiate this as well, and the majority of the analysts selected the lease rate over two others; (1) the current Bank of Canada interest rate; and (2) the company's cost of capital (See Appendix p. 158).

In most leases, however, the lessor's interest factor or earning rate will not be the effective charge experienced by the lessee. The rate the lessor charges will be meaningless if a residual value

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[46]Parker, "Discounted Cash Flow," p. 70.

[47]Myers, Accounting Research Study No. 4.p. 66, and Cohen, Leases, p. 121.

[48]Myers, Accounting Research Study No. 4, p. 46.

remains in the property and this accrues to the lessor at maturity. The effective rate to the lessee will be substantially more than the lessor's charge when based upon the property services acquired rather than the total cost of the assets leased. Only in the special case when the lessee's property rights equal the lessor's asset cost over the same period (that is, no residual value) will the lessee's rate of interest experienced be the same as that charged by the lessor. "For the lessee, the discounting process establishes the cost of services acquired, it establishes their present worth by discounting the future payments at the lessee's interest cost."[49]

In those cases where the lessee does not have direct access to the information regarding the lessor's interest charge, it would seem appropriate to use some other determinable cost of borrowing applicable to the company at the time. One method would be to capitalize the annual rentals with a factor slightly in excess of the current market rate for mortgage loans of a similar nature.[50] This premium will generally be in the range of 1/2 of 1% above the rate on direct debt obligations.[51]

However, it should be noted that even if both parties are concerned with the same stream of rental payments, their financing positions are not identical. Thus, by selecting an interest rate

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[49]Vatter, "Accounting for Leases," p. 137.

[50]Cohen, Leases, p. 122.

[51]Donald R. Grant, "Illusions in Lease Financing," Harvard Business Review (March - April, 1959), p. 126.

based on the lessee's cost of capital, a liability amount different from that of the lessor's asset will result. Myers suggests that the use of an interest rate different from that used in setting the rentals is to place a value other than cost upon the assets, and thus to mis-state the liability.[52] The rentals are set by the lessor to return an amount above the cost of the investment, and thus the lessor's interest charge may or may not be relevant to the lessee. Thus there can be some difficulty in establishing the applicable interest rate to apply, and the selection is not a mechanistic matter of choice; there are, inevitably, some elements of judgement and error involved.

The effective rate of interest charged under a lease arrangement may be computed very easily when the cost of the property is known. The property cost is compared with the total rentals payable over the term of the lease. The excess of rentals over cost can be assumed to be the premium or interest earned by the lessor for providing the leasing service. The average interest can then be determined by dividing the total interest by the number of years in the lease. When this average interest has been determined, division by the average investment will produce the rate of interest experienced by the lessee.

Some problems can arise in determing total interest paid. If the lease provides for the residual value to revert to the lessor, "...then the estimated fair market value of the property at the date

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[52] Myers, Accounting Research Study No. 4, p. 46.

the lease is to be terminated should be treated as additional interest."[53] The lessee has paid for the total value of the asset yet has benefited by some amount less than the original cost.

In an example assumed here, the lessee has contracted to lease an asset which cost the lessor $2,000,000 (see Table V). The terms of the lease specify a yearly annual payment of $174,360 at the end of each of the twenty years of the lease. The residual value of the asset at term is assumed to be $200,000, and this reverts to the lessor, since the lessee has no options at maturity. The lessor sets his rentals to return the full amount of the $2,000,000 plus interest at 6% annually. Obviously the lessee will experience an interest charge in excess of 6% since he loses the residual value but pays for the entire asset cost plus interest. The effective interest rate paid by the lessee is computed to be approximately 7.375%.

Other Considerations

Service Costs. The only amount to be capitalized under the lease should be that portion of the rental payments which give rise to the property rights. This is the asset portion of the lease with which the capitalization process is concerned and in which the service potential is embodied. If the rental payments, or a portion thereof, are for services provided by the lessor, then this amount should not be capitalized.

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[53] Nelson, Impact of Leases, p. 64.

[54] Myers, Accounting Research Study No. 4, p. 6.

TABLE V

Amortization of Lessee's Property Rights of $1,800,000

Under a Long-term Lease in the Amount of $2,000,000

Year	Payment	Interest	Amortization of Principal	Liability Balance	Depreciation	Total Charge
0				1800000		
1	174360	132120	42240	1757760	90000	222120
2	174360	129019	45341	1712419	90000	219019
3	174360	125691	48669	1663750	90000	215691
4	174360	122119	52241	1611509	90000	212119
5	174360	118184	56176	1555333	90000	208184
6	174360	114160	60200	1495133	90000	204160
7	174360	109742	64618	1430515	90000	199742
8	174360	104999	69361	1361154	90000	194999
9	174360	99808	74552	1286602	90000	189808
10	174360	94036	80324	1206278	90000	184036
11	174360	88140	86220	1120058	90000	178140
12	174360	82210	92150	1027908	90000	172210
13	174360	75148	99212	928696	90000	165148
14	174360	68166	106194	822502	90000	158166
15	174360	60372	113988	708154	90000	150372
16	174360	52005	122355	586159	90000	142005
17	174360	43024	131336	454823	90000	133024
18	174360	33384	140976	313847	90000	123384
19	174360	23036	151324	162523	90000	113036
20	174360	11837*	162523		90000	101837
	3487200	1687200	1800000	-	1800000	3487200

* Interest charge adjusted for rounding errors.

> To the extent ... that the rental payments are for services such as maintenance, insurance, property taxes, heat, light and elevator service, no asset has been acquired, and none should be recorded. To that extent, the transaction involves an agreement to make payments, period by period, for services to be rendered.[54]

Opinion No. 5 concurs that these payments for services provided by the lessor should not be capitalized and shown on the balance sheet.[55] As well, the majority of the analysts responding to the questionnaire agreed that the capitalization should include the total lease payments, but not service costs (See Appendix p. 159).

Length of Lease. Chapter 14 of Accounting Research Bulletin No. 43 suggests that, three years as one criterion for classifying leases as short-term or long-term.[56] This seems to receive the support of Myers as well.[57] While an exact separation between long-term and short-term would seem to be subject to the particulars of the lease examined, the analysts surveyed across Canada considered that a term of from three to five years would qualify a lease for long-term status (See Appendix p. 161).

The decision to capitalize also requires an opinion on the life of the asset and the term of the lease. The lessee's contractual

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[54] Myers, Accounting Research Study No. 4, p. 6.

[55] Accounting Principles Board, Opinion No. 5, p. 30.

[56] Committee on Accounting Procedure, American Institute of Certified Public Accountants, "Restatement and Revision of Accounting Research Bulletin," Accounting Research Bulletin No. 43 (New York, 1953), p. 126.

[57] Myers, Accounting Research Study No. 4, p. 23.

rights will vary at maturity, however most leases provide the lessee with the service of the asset for the majority of its useful life. This will either be through a primary lease term equal to the asset's useful life or by a provision giving the lessee the option to renew the lease at maturity for the balance of the expected asset life. If the lease provides that the lessee will receive the services of the asset for its entire useful life, then the full amount of the lease obligation should be capitalized.[58] Thus the considerations will vary in each situation as to whether the capitalization period is the primary term of the primary term plus any renewal period.

The Process of Capitalization

The lease described in Table V (p. 95) would not appear to be a purchase of property as generally described by Opinion No. 5. Yet the inclusion of the discounted lease payments on the balance sheet is permissible under Myers' theory whereby capitalization of all long-term, noncancellable leases is permitted. The property rights acquired by the lessee under the lease amount to $1,800,000. This is the lessor's cost minus the estimated fair value of the residual remaining at maturity. This is also the present value of all future rent payments discounted at the implied interest rate calculated at 7.375%. The liability would also be reflected on the balance sheet initially at $1,800,000. The appropriate description must be used to indicate the relationship that exists between the lessor and the lessee and the special status of the asset and liability amounts.

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[58] Ibid., pp. 35-38. See also Cohen, Leases, p. 121.

In Table VI a typical long-term lease is depicted in which the best estimate of the asset and liability amount in the discounted value of all future rental payments. The lessor's cost is assumed to be unknown to the lessee. The terms of the contract, in this example, require an annual rental of $175,000 annually for twenty years. It is assumed that the asset life is approximately that of the lease term, and thus residuals are negligible and the problems of maturity options eliminated. The discounting rate is determined to be 6%, which could be supported by reviewing the cost of the company's currently outstanding debt of a comparable nature. The present value of the lease property rights is therefore $2,007,250.[59]

The annual payments are applied first to the interest on the obligations under the lease and then to the repayment of the principal portion of the lease liability. The first payment includes an interest charge of $120,435 and a principal reduction of $54,565 (See Table VI p. 99).[60]

Amortization of the Lease

After considering the problems connected with the capitalization of lease rights and obligations, the next task is to determine a method

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[59]The present value of a $175,000 payment annually for 20 years, discounted at 6% is: 11.470 x $175,000 or $2,007.250.

[60]The present value of the payments for 20 years is $2,007,250. The present value of the payments for 19 years is 11.158 x $175,000 or $1,952,685. The difference, $54,565, is the present value of the first year's principal payment.

TABLE VI

Amortization of a Lease Asset and Liability in

Amount of $2,007,250.

	INDEPENDENT AMORTIZATION				CONSTANT YIELD		
Year	Payment	Interest 6%	Amortization of Asset	Total Charge	Interest	Amortization of Asset	Total Charge
1	175000	120435	100362	220797	120435	54565 (b)	175000
2	175000	117161	100362	217523	117161	57839	175000
3	175000	113690	100362	214052	113690	61310	175000
4	175000	110012	100362	210374	110012	64988	175000
5	175000	106113	100362	206475	106113	68887	175000
6	175000	101980	100362	202342	101980	73020	175000
7	175000	97598	100362	197960	97598	77402	175000
8	175000	92954	100362	193316	92954	82046	175000
9	175000	88032	100362	188394	88032	86968	175000
10	175000	82814	100362	183176	82814	92186	175000
11	175000	77282	100362	177644	77282	97718	175000
12	175000	71419	100362	171781	71419	103581	175000
13	175000	65204	100362	165566	65204	109796	175000
14	175000	58616	100362	158978	58616	116384	175000
15	175000	51633	100362	151995	51633	123367	175000
16	175000	44231	100362	144593	44231	130769	175000
17	175000	36385	100362	136747	36385	138615	175000
18	175000	28066	100362	128430	28065	146932	175000
19	175000	19252	100362	119614	19252	155748	175000
20	175000	9871	100372	110243	9871	165129	175000
	3500000	1492750	2007250 (a)	3500000	1492750	2007290	3500000

(a) Asset amount = present value $175,000 & 6%, 20 years (11,470 x $175,000 = $2,007,250).

(b) Asset amortization = P.V. 6% - 20 years (11,470 x $175,000) = $2,007,250
- P.V. 6% - 19 years (11,158 x $175,000) = $54,565

of extracting the interest expense portion from the annual rentals and of amortizing the initial cost of the property rights to income over the term of the lease. The annual adjustments to the lease liability will also be considered.

The constant charge and the decreasing charge methods are two variations of depreciating fixed assets.[61] The same methods can be applied to depreciate the asset right under a lease and to charge an annual portion of the property value to income. Similarly, under self-amortizing liabilities, each payment is explicitly divided into two components of interest and principal respectively. The annual interest expense is computed on the unpaid balance of the liability at the beginning of the period. During the life of the liability the principal portion of the payments will increase annually over the term, while the interest charge will decrease each year. This is generally considered to be the financing method of accounting for long-term leases. In as much as the leased property rights and related obligations are considered to be assets and liabilities, the accounting process can proceed in a uniform manner, with the asset charged to income by annual depreciation charges and the liability adjusted by the financing method. Shillinglaw summarized the intention of the amortization process:

> The result of the amortization procedure is to produce, at any balance sheet date, an indicated book value of the liability equal to the present worth of the remaining future lease payments, discounted at a rate equal to the initial capitalization rate.[62]

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[61]Hendriksen, <u>Accounting Theory</u>, p. 317.

[62]Gordon Shillinglaw, "Leasing and Financial Statements," <u>The Accounting Review</u> (October, 1958), p. 586.

Constant Yield Method of Amortization

The constant yield method is one approach to the amortization of the property rights capitalized under a long-term lease. In this case the asset and liability balances are reduced by an identical amount charged annually. The interest expense is calculated on the unpaid balance of the liability account and charged to income. The remainder of the rental payment, after subtracting the interest portion, is deducted from the liability account as a principal payment and is charged to income as well as the annual amortization of property rights. By this technique, the amount of the liability reduction and the depreciation charge is the same each year, and is increased as the interest portion of the rental payment is decreased. The balance sheet reflects the same amount in both the asset and liability account at each year end (See Table VI).

Independent Amortization of the Lease Asset and Obligation

An alternative to the constant yield method provides for the amortization of the asset on a basis independent of the reduction in the liability amount. There is no necessity to maintain the equality in the asset and the liability accounts past the first year. An independent amortization is more logical, since the decline in the economic usefulness of the asset requires a matching of costs to income " ...appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged."[63] Myers holds a similar view and suggests that while

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[63] Accounting Principles Board, Opinion No. 5, p. 32.

the method will vary in each situation, it will resemble that used to amortize a purchased asset.[64]

Therefore income will be charged with two independent amounts: (1) the amortization of the asset by way of a depreciation charge; and (2) the interest on the lease liability. Initially the interest charges will be high, and in combination with the property depreciation will result in a total annual charge to income of an amount greater than the actual rental expenditure. In the early years of the contract this will be the case, while in the later years the total expenses will reduce relative to the declining charge for interest. The variation in the total charge to income will be amplified if a decreasing amortization of the asset is employed, such as the declining balance method. This accounting approach allows the charges to flow to income, not on a basis of rental expenditure, but on a basis consistent with other financing arrangements, whereby asset and liability amounts are treated independently (See Table VI).

The independent amortization technique is a more logical procedure to account for long-term leases. These leases are essentially financing tools, and the treatment accorded the respective amount of assets and liabilities arising out of the lease should be divorced in terms of amortization. The disadvantage of the constant deduction approach is that it would provide for an increasing charge to operations for depreciation as the interest charged declined, assuming level lease payments. This would not be in accordance with generally accepted

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[64]Myers, Accounting Research Study No. 4, pp. 48-49.

accounting methods in which the charges are normally higher in the earlier years, and lower towards the maturity of the debt and the end of the asset's life.

These are the two important methods of accounting for the amortization of the leased asset and the related liability. Both Myers and the Accounting Principles Board agree that the independent amortization method should be employed, since it closely follows the accounting patterns established for other fixed assets. Before considering the accounting entries applicable to the independent amortization of a long-term lease, it is worth mentioning that Vatter suggests a third method of amortization.[65]

Vatter employs the independent method but he imputes an interest charge in the stream of depreciation which he considers a deferred expense. The capitalized asset value is less than that under a normal method by the amount of the deferred interest charges, but the liability is reflected at the same amount, or the present value of the discounted rental payments. The capitalized asset value is equal to the present value of the annual depreciation charges, which Vatter considers to be the leasehold cost. Thus the lessee is faced with a depreciation stream and a related interest charge on that stream, which Vatter separates from the principal portion of the asset. The lease obligation is accounted for by the financing method, suggested for the other methods of amortization.

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[65]Vatter, "Accounting for Leases," pp. 133-148.

The Accounting Process

The discussion thus far has been primarily theoretical. The ideas of capitalization and the methods of amortization have been examined as they relate to the asset and liability amounts under the lease. The accounting entries required to initiate the process, as well as the annual adjustments, can now be suggested. The approach advocated by Myers and the Accounting Principles Board will be followed.

Myers used the independent amortization process to account for the asset and liability under the lease.[66] The asset is charged to income by annual depreciation, while the liability is adjusted by the financing method. The example used to illustrate the accounting process is shown in Table VI, which was discussed above.

The capitalized asset value of the property rights under the lease is $2,007,250, which is the value of the annual stream of rental payments of $175,000 discounted over twenty years at six percent. The straight line depreciation method is selected to charge this asset value to income over the lease's term. The amount of the equal annual charge is $100,362.

By considering the lease liability on a financing basis, together with the independent amortization of the asset, the annual rental payments are considered to be payments for interest on the loan and payments of loan principal. Interest on the liability was calculated at six percent annually on the unpaid balance. The total charges to income exceed the amount of rental payments until the twelfth year, because of the interest factor.

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[66] Myers, Accounting Research Study No. 4, Chapter 4.

The present value of the future rentals payable and the property rights under the lease are recorded by the entry:[67]

(1) Dr. Rights to Use of Leased Property $2,007,250

Cr. Rental Obligations Under Long-Term Leases $2,007,250

The account description must be such that the reader is fully aware that the assets and related liabilities arise out of a lease contract. The asset acount "Right to Use Leased Property" should be shown on the balance sheet as a fixed asset, and included in the totals for this category. The property rights in the asset section will be reduced directly by the annual amortization, rather than by an asset valuation account, such as accumulated depreciation.

The annual depreciation entry to amortize the asset is:

(2) Dr. Depreciation Leased Assets $130,362

Cr. Right to Use Leased Assets $130,362

The account "Rental Obligation Under Leases" is included among the long-term liabilities. The current portion payable within the year is reflected as a current liability. The long-term liability should carry a suitable description to indicate the method of determining the liability value, such as "Rental Obligations Under Leases, discounted at __% through October 19__, less $__________ due within one year."[68]

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[67]Arthur Andersen and Co., Accounting and Reporting Problems of the Accounting Profession (2nd ed.; 1962), p. 33.

[68]Ibid.

From the schedule of repayments, the long-term liability account is adjusted to include the periodic interest charge implicit in the lease contract:

(3)	Dr. Rental Obligations Under Long-Term Leases	$54,565	
	Dr. Interest Charges on Long-Term Leases	$120,435	
	Cr. Accrued Rentals Payable		$175,000

When the annual rental is paid, the liability under the above entry would be eliminated:

(4)	Dr. Accrued Rentals Payable	$175,000	
	Cr. Bank		$175,000

Each payment thus includes a portion of interest, calculated on the unpaid balance in the liability account, as well as a principal portion of the liability itself. The annual charges to income, and the applicable reductions of the liability account, are performed on a financing basis as summarized in Table VI.

The above illustration of the independent amortization process follows the same accounting methods used for other fixed asset and long-term liability accounts. As Vatter remarks, "... the use of leases does not suspend the operation of principles which govern the recognition and assignment of costs and revenues..."[69] The peculiarity of this process is that the asset is not always recorded at an experienced, historical cost. Instead, the discounting process established the cost of services acquired by the lessee, which is not necessarily the same as the cost of the asset.

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[69]Vatter, "Accounting for Leases," p. 148.

If the constant yield method is employed, the accounting entries would take the same form as those under the independent amortization approach, however the amount of the annual depreciation charge would vary from the above example. In Table VI the entries for the constant yield method are summarized. The sum of the yearly charges to income would always be equal to the annual rental payment, or $175,000 in this example. The interest on the lease liability is calculated in the same manner as under the independent approach and the interest amounts and timing are identical. The depreciation charge, however, is increased annually as the interest charge is decreased. This provides an increasing property charge over the lease term, which is normally not experienced in the amortization of other fixed assets. Thus the lease costs are matched to income in a fashion similar to the case where the lessee treats the annual lease payments as expenses as they are paid or accrued. Since the total annual charges are always the same, this process produces a constant yield over the term. The asset and liability accounts always reflect the same balance at each year end.

The method to apply to the amortization of property rights and liabilities under a lease will depend largely on the expiration of costs and should not be an arbitrary selection adopted by default.[70] The independent amortization approach seems to be the most appropriate method, however Shillinglaw believes the constant yield method to be the better alternative.[71] Vatter has shown that the selection need

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[70] Vatter, "Accounting for Leases," p. 148.

[71] Shillinglaw, "Leasing and Financial Statements," p. 587.

not be limited to the two methods suggested,[72] which seems to be a better philosophy, and in accord with changing reporting requirements and evolving accounting practice.

Accounting for Sale and Leaseback Transactions

The Accounting for long-term leases can be complicated when the lease takes the form of a sale and leaseback. If the premise that leasing provides long-term financing is accepted, then the sale and leaseback is but one economic transaction, a method of securing long-term funds on the security of the asset involved. The accounting treatment should look through the sale and leaseback intricacies and treat the scheme as an integrated arrangement providing secured capital.

The other view is that the sale and the lease should be viewed as two separate transactions, the sale and the subsequent leaseback of the property. In this latter interpretation, problems can arise with respect to the handling of any gain or loss on the sale. This presents the task of deciding how to report the gain or loss in the financial statements: as an adjustment to income in the year of transaction, or by spreading the difference over the life of the lease as an adjustment to the property depreciation expense?

Myers claims that the sale and leaseback is but one economic transaction, which eliminates any problem of profit or loss adjustment:

> Since the sale and leaseback seems to be but a single economic transaction and since its major (or sole) purpose is to raise money with certain property rights given as security, the transaction should be recorded as a single, financing transaction. The debit would be to cash and the credit to an appropriate designated liability. The

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[72]Vatter, "Accounting for Leases," p. 148.

> property accounts would remain on the books to be depreciated in the usual manner. Periodic rental payments would be charged in part against income (the interest element of the payment) and the remainder against the liability. The question of how to handle a gain or loss on the sale and leaseback would not arise, because no property has been removed from the balance sheet in exchange for cash. Appropriate recognition should be given to the changed legal status of the property in subsequent balance sheets.[73]

While Myers considers that there is no gain or loss on the transaction and that the asset is not sold except in the strict legal sense, others feel that the fact of the sale requires somewhat more detailed accounting treatment.[74] The latter group views the transaction as two interrelated but separate parts: the sale and the leaseback. The asset should be eliminated from the accounts and the lease right set up in its place at the discounted value of future rentals.

If the asset is recorded at the discounted value of future rentals, rather than treated as a financing arrangement with no accounting adjustments made, then the asset is shown at the present value of the future principal payments under the lease. If there is no gain or loss on disposal, then the method advocated by Myers and this approach would give the same balance sheet disclosure, since the cost of the asset is equal to the discounted value of the future stream of rental payments over the term of the lease. If the sale of the property results in a gain or loss, then this amount "... should be amortized over the life of the lease as an adjustment of the rental cost (or, if the leased property is capitalized, as an adjustment of

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[73] Myers, Accounting Research Study No. 4, p. 51.

[74] Arthur Anderson & Co., Reporting Problems, p. 36.

depreciation)."[75] Thus the future costs of the lessee are increased by a loss or decreased by any gain. It seems that Opinion No. 5 would permit the capitalization of the sale and leaseback asset at a value greater than the asset's book value immediately before the sale. The opinion would apply only in those instances where the sale and leaseback is clearly in substance a purchase of property. It should be noted that under either interpretation of the single transaction approach, the same charge will be made to income. The difference is in the balance sheet presentation. Myers, of course, would capitalize all sale and leasebacks at the book value of the asset immediately before sale, regardless of the nature of the arrangement.

These two methods of accounting for a sale and leaseback are somewhat involved. In summary, Myers shows the leased property rights of the asset's depreciated cost before the sale and treats the funds provided from the sale and leaseback as an ordinary loan. All long-term, noncancellable leases are handled in this manner. Opinion No. 5 considers for capitalization only those leases which are in substance purchases of the property. The capitalized value of the property rights to be recorded is the discounted value of the future rental payments. Thus the asset value, as described by Opinion No. 5, can vary from cost (or is revalued) if there is a profit of loss on the sale.

However, a third possibility can occur. Mulandro suggests that "if the leaseback is not in substance a repurchase, then the property rights acquired and the related obligations should be reflected

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[75] Accounting Principles Board, Opinion No. 5, p. 33.

in the statements following the same procedures suggested for other financing leases."[76] In other words, Mulandro would revalue the capitalized asset if the lease was a right to use lease and would not revalue the asset under a purchase equivalent lease. This approach suggests the same balance sheet disclosure of the asset as Myers, providing a right to use lease is not sold at a gain or loss. Mulandro's treatment of a purchase equivalent is identical to that of Myers:

> If the leaseback is in substance a repurchase agreement the proceeds from the sale would be the equivalent of a loan obtained with the property serving as the security. The valuation of the asset would not change but the total obligation would be properly disclosed in the liability section of the balance sheet.[77]

Canadian Practice Regarding Sale and Leasebacks

Sale and leasebacks are disclosed exclusively by footnotes in Canada, in the same reporting manner used for other long-term leases. Several of the companies reviewed presented information with respect to the gain or loss on disposal from sale and leaseback arrangements. Loblaw Groceteria Co. Limited, for one, provided a good disclosure in so far as the footnote approach is concerned. The information as to sale and leasebacks during the year was given, including: the nature of the relationship with the purchasing company; the gain or loss on disposal; and the rental particulars. Loblaws carried an account,

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[76] Rudolph Mulandro, Financial Reporting of Long-Term Leases, Bureau of Economic and Business Research, Number Six (Kent, Ohio: Kent State University, 1965), p. 70.

[77] Ibid., p. 70.

"Deferred Real Estate Income", which included the gains from various leaseback transactions. Each year a portion of this deferred revenue was taken into income. The statement provided the following notation: "... excess of sale price over depreciated cost of certain properties sold and leased back. Amortization during the year amounted to $435,095."[78] The gain is amortized over the life of the respective lease giving rise to the credit.

Suggested Method of Accounting for Sale and Leasebacks

In view of the arguments presented, not only on the merits and essence of long-term leases *per se*, but also from the discussion on sale and leasebacks, it seems that Myers presents the most logical and uniform method of accounting for these transactions. He presents a consistent case which views leasing as a method of long-term financing, and eliminates the problem of adjusting for gains or losses on disposal. Myers shows the asset on the balance sheet at its historic cost, and the corresponding financial liability at the value of the sale amount. The cost reflects the discounted value of rental payments, as in other lease situations. Proper footnote information includes particulars of the sale and leaseback, disclosing the special nature of the property rights included among the assets.

Summary

The vital role which financial statements play in the decision-making process of both corporate managers and investors makes it absolutely necessary that an accurate report of the entity's operation be

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[78]Loblaw Groceteria Co., Limited, *Annual Report 1967*.

contained in the financial statements. Whether this is possible with the present footnote technique of long-term lease disclosure is questionable. From a review of the normative practice suggested, it seems that footnotes are an incomplete method of displaying information which should be reflected correctly on the balance sheet itself. The assets and liabilities are understated to the extent that long-term lease amounts are not recorded directly. This affects some of the significant financial ratios which compare, for example, debt to equity, or fixed assets to equity. The comparability of companies is restricted, especially between those who use conventional debt forms and those who employ long-term leases. The financial analysts and other users of financial statements cannot carry out a complete analytical examination from the information currently contained in footnotes. Thus the capitalization procedure cannot be used even as an analytical device to adjust the important financial ratios. As a result, arbitrary decisions are required that are based on incomplete information.

There is little doubt that the lessee, under a long-term, non-cancellable lease, receives most of the privileges and rights accorded asset ownership. The legal failing in title cannot be an acceptable reason for the exclusion of these material amounts from the balance sheet. The asset value does exist in the property rights received by the lessee under the service potential concept. The lease liability, as a charge on the entity's entire asset pool, deserves proper recognition in the accounts.

While the capitalization process does involve some judgement in applying the mechanics of the technique, it can provide an effective

method of accounting for the property rights and related obligations under a lease. The amortization process, most reasonable and analogous to the accounting practice established for other fixed assets, would be the independent amortization approach. The asset is depreciated on some normal basis, consistent with the company's policy and circumstances, while the liability is treated as secured borrowing and the financing method applied. The asset and liability reduction need not be uniform and in agreement, nor should the annual amortization and interest charge be restricted to the total of the annual rentals paid.

The capitalization method will provide for a logical and consistent approach to reporting, which is one of the most compelling reasons for the acceptance of this process. There will have to be some agreement reached in Canada with respect to the accounting principles to employ. The choice seems to be between the approach suggested by Myers or that of the AICPA Accounting Principles Board, Myers' suggestion for the capitalization of all long-term leases seems to be the most reasonable and consistent approach. However for those who consider some leases to be less than complete financing arrangements, Opinion No. 5 provides a division between purchase equivalents and right ot use leases. The Committee on Accounting and Auditing Research must give special consideration to the question of the financial presentation of long-term leases and provide authoritative support to their proposed accounting procedures.

Chapter V

SUMMARY AND RECOMMENDATIONS

Introduction

The problem examined in this thesis is whether or not long-term, noncancellable leases should be reported directly on the balance sheet of the lessee, at the present value of the future rental payments under the contract. Most of the study was a theoretical discussion of the capitalization method as an approach to improved financial statement disclosure of these leases. A questionnaire was employed to provide some empirical evidence as to the nature of leases and the related reporting problems and to determine if capitalization could be accepted as a method of disclosure in Canada.

The majority of the respondents to the questionnaire did not favor capitalization as a reporting technique. However, they agreed that long-term leasing is as much a method of debt financing as is borrowing by conventional means, such as mortgages or bonds. The analysts suggested that current financial statements failed to disclose sufficient information on long-term leases and requested that more details should be given, including: the annual rental, the term of the lease, the maturity date and the lessee's options. While those replying maintained their devotion to the current, conservative reporting practices, their request for more information in footnotes tended to reinforce the argument that the disclosure through notes to the balance sheet is an inadequate and incomplete method. It can also be concluded that the recommendations of Bulletin No. 20 regarding the long-term leases are ignored in practice. This agrees with the conclusion reached by the Canadian Institue of

Chartered Accountants who indicated that in 1966 only 20% of their survey of those companies making reference to long-term leases met the minimum disclosure requirements of Bulletin No. 20.[1] It is therefore obvious that the current Canadian accounting conventions are ignored in practice, and probably inadequate in outlining the amount of information to be provided to the users of financial statements.

Capitalization: The Deductive Approach

The prescribed Canadian accounting practice for long-term leases is to disclose relevant information in a footnote to the balance sheet. The American Institute of Certified Public Accountants recommends that footnote disclosure is acceptable for those leases which provide the lessee with the right to use the asset where the lessee is not establishing an equity in the property. Those leases, which are in substance installment purchases of the property by the lessee, should be capitalized and included among the assets and liabilities of the entity at the appropriate discounted value of the future payments under the lease. Accounting Research Study No. 4 suggests that all long-term, noncancellable leases should be capitalized and reported directly on the balance sheet.

The present Canadian accounting standards do not recognize that any asset or liability amount is created under a long-term lease, not even in the situation where the lease is essentially an installment purchase arrangement. Obviously the Canadian accounting methods are

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[1] The Canadian Institute of Chartered Accountants, Financial Reporting in Canada, Seventh Edition 1967 (Toronto: Canadian Institute of Chartered Accountants, 1967), p. 62.

outdated since the recommended practice essentially suggests that an entity understate the assets and liabilities reported. This is a serious accounting deficiency and the resulting financial statements of a lessee are worthless if a major portion of the assets are leased. Analytical studies using inter-company or inter-industry comparisons of those ratios combining debt, equity or asset amounts, are meaningless without an adjustment for the capitalized asset and liability amounts under a lease, and these calculations are very difficult with the amount of information now disclosed.

The long-term lease is one method of financing the acquisition of fixed assets and it is very similar to other secured borrowing forms such as mortgages or bonds. The lessor provides the lessee with the uninterrupted use of the leased asset in return for an agreed annual payment. The obligation to pay for the use of the asset annually is enforced by the lease contract. The lessor expects to earn a return on the investment for providing the financing, but foregoes any other claim to the asset during the term of the lease. Thus a lease arrangement is nothing less than a long-term financing method with a peculiar feature which allows the investor (lessor) to retain title to the asset, much the same as an agreement for sale contract.

However, with an agreement for sale arrangement the title remains with the vendor until the liability has been paid, yet the purchaser of the assets automatically includes the asset and liability amounts on the balance sheet. A long-term, noncancellable lease is a similar agreement, except that the purchase agreement is often absent in the contract. Essentially the lease provides the lessee with the service potential of

the asset which will be used to earn income over the term of the contract. The user of the asset does not need title to the asset to enjoy or acquire the economic resources embodied in the property, but there must be some consideration given in return for this right. A lease or an agreement for sale provides the user of the property with an asset value under the service potential notion of assets, and as well establishes a related obligation to pay for the financing service. To have a more realistic estimate of an entity's financial position the asset and liability items under a lease should be included on the balance sheet for proper disclosure, even though the lease does not always constitute a purchase arrangement.

A measure of the asset value acquired under a lease is the present value of the future, periodic, rental payments over the term. The main problem of this measurement is the selection of the discounting rate which will equate the future lease payments to the present value of the property rights received. The implicit interest rate of the lease itself or the lessee's approximate cost of capital are suggested as appropriate rates. However any rate is partly subjective, since the question always arises as to whether or not the rate is applicable to the firm and the transaction being measured. Only the principal amounts of the lease payment are capitalized, and any payments made by the lessee for services, such as taxes or maintenance, should not be included.

Once the asset has been reflected in the accounts of the lessee, the measurement of the expense items can proceed on a basis similar to that for owned assets. The property rights are amortized by periodic depreciation charges to income. The method of depreciation will vary

in each situation and straight-line or double declining balance are two acceptable approaches. The timing of the amortization of the asset is independent of the annual rental payments or the amortization of the liability under the lease.

The liability will be amortized on a financing basis, whereby the rental payments apply first to the interest on the obligation, and then to the reduction of the principal balance. The lease liability is equal to the asset value at the outset of the arrangement but is accounted for on an independent basis thereafter. Interest is calculated on the unpaid balance remaining in the liability account by applying the interest rate used to capitalize the lease payments. This amount is charged to expense annually as a financial expense, and together with the amortization of the property charge, can exceed the total payments under the lease. Because of this change in the timing of expenses matched to income, the total charges will be higher in the early years of the contract than in later years, particularly if the double declining balance method of depreciating the property rights is used. This independent method of determining income will result in an accounting pattern which approximates that of other assets, in which the total charges associated with the asset and the related liability decrease with time.

The capitalization of lease rental payments is thus a reasonable method of accounting for the asset, the liability and the related income charges under a long-term lease. Certain subjective elements are present in the discounting process, however any shortcomings are relatively immaterial compared to the improved disclosure possible through capitalization. The independent method of accounting for the asset and

liability provides an even better disclosure, since this approach treats leased assets in the same manner as other fixed assets.

Capitalization: a Practical Approach

The majority of the replies (52%) from both the analysts and companies surveyed were not in favor of the formal capitalization of long-term leases as a standard method of disclosure. This percentage does not appear to indicate a strong denial of capitalization. It should be noted, however, that 19% of the respondents indicated that capitalization was possible under special circumstances. This choice may have been selected by those who had no definite opinion but wished to express some idea and thus selected a moderate position. The number of replies indicating a definite preference for capitalization was only 29%.

The main reason given to oppose the capitalization method of disclosure was that the footnote approach is adequate. As well, the respondents believed that the capitalization process involved too many arbitrary and subjective decisions which offset any advantage obtained in the direct reporting of the asset and liability amounts. As a result, the financial statements would provide only approximate values for the leased assets, and since the basis of valuation is not the same as for the other assets, capitalization is not much of an improvement over footnote disclosure. One of the companies believed that they would be losing an important opportunity to understate the entity's liabilities if the capitalization and direct reporting of long-term lease obligations was required. Generally these reasons do not endure a close, objective examination and are essentially peculiar accounting privileges granted to those firms who elect to finance fixed asset acquisition by leases

rather than other conventional debt forms.

Those respondents who favored the capitalization method of reporting long-term leases (29%) suggested that inter-company and inter-industry comparisons could be improved by this disclosure technique. The parallel between lease financing and other formal debt arrangements was recognized by many proponents of capitalization. They emphasized that since leasing is considered to be a debt form, it should be reported in a similar manner as other long-term liabilities. The lessee's title "deficiency" was not considered to be critical to the final decision as to whether capitalization is necessary or not. An important opinion was expressed by several analysts who indicated that their decision to capitalize long-term lease payments would depend upon the circumstances and nature of the arrangement (19%). In particular they believed that those leases which were actually long-term purchase agreements could be disclosed better through the direct capitalization of the property rights and the related liability.

Although the survey did not support capitalization as an acceptable method of reporting long-term leases, the majority of the analysts replying considered the amount of lease information usually disclosed in footnotes to the financial statements to be inadequate for their analytical needs (67%). More specifically, the analysts requested that more details should be provided, including: the annual rentals, the lessee's options, the term of the lease, and the nature of the relationship with the lessor. What these analysts have requested is the disclosure recommended by Bulletin No. 20. Obviously the prescribed footnote disclosure of the Committee on Accounting and Auditing Research is ignored in

practice. These accounting standards are not only inadequate for the purposes of financial statement users, but also are not applied on any consistent or uniform basis in Canada.[2] The survey results indicated that while footnote disclosure is an incomplete and inadequate method, the users of long-term leases and the financial analysts are not prepared to recommend direct capitalization as a method of improving financial statement reporting. However, several respondents (13%) were in favor of the inclusion of the capitalized property rights in the long-term lease footnote, together with a complete explanation of the nature of these items, and the possible effects these values may have on the entity's financial position.

It is not clear why the respondents favored a more detailed long-term lease disclosure while rejecting capitalization as a method of improved reporting. It may be suggested that the companies, in particular, are not completely familiar with the basic financial aspects of leasing, and do not see through some of the illusory advantages proposed for leasing. The possibility also exists that analysts are out-of-date on current reporting practices. The Canadian accounting profession may be at fault as well, since there has been little leadership or education provided to secure improved financial statement disclosure of long-term leases. However the financial analysts and those companies who are interested in lease financing arrangements must recognize that only if direct capitalization is employed can uniform and consistent reporting standards be achieved. If leases are recognized as a form

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[2] *Ibid.*, p. 62.

of long-term debt, as the questionnaire indicates, the financial statements must disclose the economic and financial facts of the lease transaction on an acceptable accounting basis, which recognizes the problems of capitalization, including: the discount rate to be used; and the method of amortization of the asset and liability amount.

There is no doubt that the financial lease is recognized as a debt form comparable to other long-term liabilities. The lease, as a source of capital, is considered a part of the company's total available credit. The respondents to the questionnaire most often ranked it between secured mortgage debt and unsecured debentures (39%) in terms of security of investment and recovery of principal. The predicted increase in the use of the long-term lease and the lease's similarity to conventional debt forms suggests better financial statement disclosure of this part of an entity's total debt obligation.

Recommendations

The accounting standards for the reporting of long-term leases must be updated. The responsibility for improving disclosure practices rests with the Canadian accounting profession who must provide some meaningful guidelines applicable to the reporting problems of long-term leases.

One major problem will be to decide if there is any basic distinction between leases which are in substance purchases of the property and leases which provide the lessee with the right to use the property. Should the Canadian practice differentiate between these two types and recommend a specific accounting treatment for each? If the American practice is followed, then only those leases which are purchases of the

property are suggested for capitalization, while those leases which convey the right to use the asset are reported in footnotes only. If the recommendations of the Accounting Research Study No. 4 are accepted, all long-term, noncancellable leases are capitalized. These are the apparent alternatives and to recommend either capitalization method presents the problem of convincing the financial community of the improvements possible in this form of long-term lease disclosure.

A normative conclusion is possible, since the reasoning in favor of capitalization recognizes the substance of the transaction rather than the form. If the lease is noncancellable and for a term of at least three years, then the substance of the transaction has been to provide the lessee with all the rights and obligations normally associated with asset ownership. The lessee receives the service potential of the asset for the term of the lease and in return agrees to pay the lessor an annual amount which is a combination of principal payment and interest charge. The noncancellable feature of a lease is one reason in support of capitalizing the annual lease payments. Therefore the capitalization of all long-term, noncancellable leases can be suggested, not a pretentious method of reporting, but as a logical approach to improved financial statement disclosure in which the presentation looks beyond the form of the transaction. The lessee has acquired a fixed asset under the lease with a related obligation to pay for its services over a future period of time.

The attitude survey did not support the contention that all long-term, noncancellable leases should be capitalized. Although inadequate in their information content, footnotes are still preferred as

the method of balance sheet disclosure. This is not an emphatic denial of capitalization entirely, since several respondents favored the capitalization of lease payments when the contract was in substance a purchase of the property. It was generally agreed, moreover, that a greater amount of lease information needed to be included in the lessee's financial statements. Thus the problem is not that disclosure is required but that a method of reporting must be suggested which provides a consistent and uniform approach of presenting long-term leases in the financial statements.

The principal recommendation of this study, which combines the results of the normative review and the attitude survey, is that those long-term, noncancellable leases which are in substance purchases of the property should be capitalized and included among the assets and liabilities of the entity, exclusive of any portion of the rentals which may be for services provided by the lessor. Those leases which provide the lessee with the right to use the property should be disclosed in a footnote to the balance sheet including the full particulars of the lease, as is currently required by Bulletin No. 20.

This recommendation has several very obvious shortcomings. The use of footnotes for right to use leases perpetuates the basic weakness of the current Canadian practice, in that no uniform or consistent amount of information is disclosed. As well, the reader is forced to determine for himself the impact of the lease property right and obligation on the entity's overall financial position, and in many instances this requires some very arbitrary decisions which may or may not benefit the organization. The footnote is often ignored as an information

source of much importance, except by those users of financial statements who are aware of the particulars which are typically disclosed in this manner.[3] Finally, the use of the footnote, except as a supporting disclosure device for capitalized amounts, fails to recognize that the long-term lease is nothing less than a long-term financing arrangement.

While the recommendation may be criticized for not suggesting the complete capitalization of all long-term leases, the adoption of the approach suggested here would serve as a transitional reporting method. It may be too drastic a departure from the conservative reporting practices currently employed to prescribe capitalization for all lease transactions. As a first step, however, the capitalization of those leases which are in substance purchases of the property will introduce the companies and the users of financial statements to the benefits to be gained from this reporting method, such as: a better measurement of the entity's resources; a better matching and timing of the charges to income; and a better indication of the claims against the entity. By adopting this recommendation, Canadian accounting practice would at least be comparable to the disclosure standards in the United States. This in itself will provide improved comparability between international corporations, as well as providing some uniformity and consistency for all firms disclosing long-term leases.

The analysts replying to the questionnaires did not agree that all leased assets should be capitalized. They indicated that real

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[3] Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 459.

property leases, such as those for real estate and buildings or branch sales offices could be capitalized, but they did not agree that such assets as electronic computing equipment, trucks, standard machine tools, or special production equipment should be reported directly. They indicated that because of the special nature of sale and and lease-back contracts, which are essentially purchase arrangements, that capitalization would improve the disclosure of these leases. It seems that the recommendation of this study, to capitalize only those leases which are in substance purchases of the property, would follow from the results of the questionnaire. Sale and leaseback arrangements normally involve real property and because of the purchase option which is often included in these leases, they are installment purchase plans, and they should be capitalized and included on the balance sheet for proper disclosure.

Limitations of the Study

The questionnaire contained several questions which provided very little information. In particular question twelve in the analyst questionnaire was generally not completed. This question required the respondents to reflect their adjustments for long-term leases on a simple balance sheet and operating statement, regarding such items as long-term debt, current liabilities, fixed charges, and total assets employed. It seems that the calculations required too much of the respondents' time and most elected to ignore the question. This may limit to some extent the responses to question eleven of the same questionnaire, which were employed to evaluate long-term lease commitments. A major portion of the analysts indicated, in particular, that they

normally discounted the annual lease payments and reflected the capitalized values in the balance sheet amounts for analytical purposes. However these analysts failed to reply to question twelve which asked for the adjustments normally performed to reflect the lease commitments. Therefore there is some doubt that the analysts are as thorough in their analysis of leases as indicated by question eleven. The appendix does not, therefore, summarize the results of question twelve, parts (a) and (b), from the analyst questionnaire.

There were several "open-end" questions in both questionnaires which were not completed, and thus the respondent's reasons or opinions were omitted. This is a weakness of providing a question which requires a selection or ranking of several possible responses and a space for an explanation. Normally once the selection has been indicated, the respondent feels he has completed the question. These multiple choice questions also tend to lead the reader and may suggest answers which would not be mentioned in an "open-end" question.

The number of responses may have been reduced as a result of the national mail strike. The questionnaires were mailed immediately following the strike and several questionnaires may have been misplaced in the mass of more important mail arriving at the offices solicited. The follow-up letters reinforced this assumption as many letters were received from the various companies indicating that the questionnaire could not be located. Second copies of the questionnaire were mailed to these firms, who promised immediate responses, but at cut-off date several of these were as yet outstanding. Despite this major problem the analysts returned 32% of their questionnaires, while the companies'

response rate was 41%.

The positions of the company officers replying to the questionnaire may have influenced the results as well. In those instances where an accompanying letter was returned or the questionnaire was signed, the signing officer was often in a managerial position. It is assumed, however, that many of the questionnaires were completed by people in lower positions who may not have been completely familiar with the problems and peculiarities of long-term leases or capitalization, to the extent that they could suggest changes or improvements in reporting techniques. This possible lack of familiarity with current financial statement disclosure may have influenced the responses. Particularly, the multiple choice questions may have been answered in a random or haphazard fashion, without much attention to the consequences of the choice. It is also possible that the overall response rate for the two questionnaires was reduced because of the theoretical nature of the questionnaire, which embraced a topic which is not immediately familiar to most financial analysts or company officers.

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Appendix A

Abstracts and Summary of Questionnaires

ANALYST'S SURVEY

1. Typically a company's long-term capital sources have been ranked in terms of decreasing certainty of return on investment and recovery of principal in the following order: secured mortgage debt, unsecured debentures, subordinated debt, preferred stock, common stock.

   Do you consider long-term leases, (i.e. more than three years), to be a new source of corporate capital and thus serving to expand the company's available credit pool?

   YES ☐ NO ☐

   If yes, how would you rank it among the more conventional sources of corporate capital in terms of decreasing certainty of return on investment and recovery of principal?

   Please mark the <u>one</u> box which most closely reflects your ranking.

   (a) more secure than secured mortgage debt ☐
   (b) about the same as secured mortgage debt ☐
   (c) after secured mortgage debt but before unsecured debentures ☐
   (d) about the same as unsecured debentures ☐
   (e) after unsecured debentures but before subordinated debentures ☐
   (f) about the same as subordinated debentures ☐
   (g) after subordinated debentures but before preferred stock ☐
   (h) about the same as preferred stock ☐
   (i) about the same as common stock ☐

2. What reasons can you provide to support your opinion in Question 1? Please explain.

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3. If you had to consider the investment possibility of a long-term lease, what principal factors would you deem important in apprai-sing the security of the investment?

   Please mark the following suggested factors in order of importance by the numbers 1 through 5.

   (a) the nature and value of the property leased ☐

   (b) the renewal options sought by the lessee ☐

   (c) the credit of the lessee ☐

   (d) the term of the lease and the implicit return on investment ☐

   (e) other provisions of the lease, such as cancellation, maintenance and insurance, etc. ☐

4. Consider the following hypothetical lease problem:

   A company with a prime credit rating sells a new factory building to a financial institution and leases it back on a 20 year, non-cancellable lease. The 20 annual lease payments are set at an amount which will permit the financial institution to recover its investment and earn interest at approximately 8%. The company must also pay all service costs such as maintenance, taxes and insurance, as well as lease payments. This company also could have borrowed an amount equal to the lease from the same institution through 20 year unsecured debentures at 7%.

   In your opinion, why was the financial institution able to obtain a higher rate (8%) on the lease transaction than it could have earned on a loan (7%)?

   Please check only <u>one</u> box indicating the most important reason.

   (a) The lessor has a greater risk of loss, or less security of investment in the lease. ☐

   (b) The lessor must incur greater administrative and financial costs which are associated with leasing. ☐

   (c) No logical reason for a higher lease rate, except skillful negotiation of terms. ☐

   (d) Other reasons - please note. ☐

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From the information in the hypothetical example in Question 4, consider the following problems in Questions 5, 6, 7 and 8.

5. If you were to capitalize the lease commitments as a formal analytical technique, what rate would you use to discount the future payments to present value?

   Please mark only one.

   (a) the current Bank of Canada interest rate ☐
   (b) the company's cost of capital, if roughly known ☐
   (c) the rate of the specific lease agreement, i.e., 8% ☐
   (d) other, please specify ☐

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   ____
   ____

6. If you were to capitalize the lease commitments, what portion of the annual lease payments would you capitalize?

   Please mark one.

   (a) total payments made by the lessee to the lessor including lease payments and other service costs for maintenance, etc. ☐
   (b) total lease payments, but not including service costs ☐
   (c) a portion of the lease payments ☐
   (d) other, please specify ☐

   ____
   ____

7. Would your decision to capitalize annual lease payments depend upon the nature of the assets leased?

   YES ☐ NO ☐

   If yes, would you capitalize the following:

	YES	NO
(a) electronic computing equipment	☐	☐
(b) branch sales offices	☐	☐

(question 7 continued)

(Question 7 continued)

	YES	NO
(c) automobiles and trucks	☐	☐
(d) standard machine tools	☐	☐
(e) special production equipment	☐	☐
(f) real estate and buildings	☐	☐

8. Would your decision to capitalize annual lease payments depend upon the length or remaining term of the lease?

YES ☐ NO ☐

If yes, consider the following periods of lease commitments:

	YES	NO
(a) 1 year	☐	☐
(b) 2 years	☐	☐
(c) 3 - 5 years	☐	☐
(d) 6 - 10 years	☐	☐
(e) 10 - 20 years	☐	☐

9. Do you feel that the typical Canadian accounting practice of footnote disclosure of long-term lease commitments provides enough information for users of financial statements to determine the implications of leasing on a company's financial position?

YES ☐ NO ☐

10. Do you feel there is merit in the formal capitalization of discounted annual lease payments within the balance sheet, (i.e. as an asset and liability), as a standard method of disclosure?

YES ☐ SOMETIMES, DEPENDING ON CIRCUMSTANCES ☐ ☐ NO

Please explain briefly the reason(s)for your opinion.

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11. Which of the following procedures would you normally employ to evaluate long-term lease commitments, assuming they are material?

Please check all those applicable and in common use by yourself or your firm.

(a) as a separate factor to be used in reaching a final appraisal of the firm ☐

(b) as a comparative ratio; expressed, for example, in relation to sales, assets, or total earnings on an industry or inter-company basis ☐

(c) as a portion of the fixed charges, to be included in interest charges and debt repayment obligations to determine fixed charges and cash flow coverage ☐

(d) by discounting and capitalizing in some way the value of all lease payments to be made in the future ☐

(e) other, please specify ☐

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Shown below is an example of a set of condensed financial statements from a Canadian food chain company, as at December 31, 1967.

BALANCE SHEET

Current Assets	$300,000,000
Less Current Liabilities	200,000,000
Net Current Assets	100,000,000
Fixed Assets (Net Depreciation)	232,000,000
Total Assets less Current Liabilities	332,000,000
Less Long-Term Debt	80,000,000
Capital Stock and Surplus	252,000,000

INCOME STATEMENT

Sales		$2,500,000,000
Cost of Sales and Expenses		2,420,000,000
Operating Profit		80,000,000
Rentals on long-term leases	$40,000,000	
Interest on long-term debt	5,000,000	45,000,000
Profit Before Income Taxes		35,000,000
Less Income Taxes		15,000,000
Net Profit for the Year		20,000,000

(continued)

The footnote disclosure of long-term leases reflects the aggregate minimum rentals over five consecutive five-year periods, exclusive of charges for taxes, insurance, and other occupancy costs to be paid by the Company.

	Minimum Aggregate Payments	Annual Payments
1968-1972	$150,000,000	$30,000,000
1973-1977	120,000,000	24,000,000
1978-1982	70,000,000	14,000,000
1983-1987	35,000,000	7,000,000
1988-1992	15,000,000	3,000,000
after 1992	10,000,000	2,000,000
	$400,000,000	

12. From the above financial statements provide the following information.

(a) Do you feel the lease obligations are material in this case, and deserving of special treatment in analyzing the company's performance?

YES ☐ NO ☐

(b) Complete the following schedule which adjusts for lease obligations. If you feel no adjustments are necessary indicate "none". Please show calculations.

	BEFORE LEASE ADJUSTMENTS	AFTER LEASE ADJUSTMENTS
(i) Long-term debt;		
(ii) Fixed Charges;		
(iii) Total Current Liabilities;		
(iv) Total Assets;		

(Question 12 continued)

(c) Do you feel that the financial ratios computed from conventional statements could be any more meaningful by capitalization of long-term leases?

YES ☐ SOMETIMES, DEPENDING ON CIRCUMSTANCES ☐ NO ☐

Please explain briefly the reason(s) for your answer.

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13. Do you consider long-term leases which are essentially purchase arrangements, e.g., sale and leasebacks, to be any different in nature from other long-term, noncancellable leases?

YES ☐ SOMETIMES, DEPENDING ON CIRCUMSTANCES ☐ NO ☐

Please give a brief reason for your answer.

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14. Briefly describe those improvements which you feel should be made in financial statement disclosure of long-term leases.

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COMPANY SURVEY

1. Please select any two of the following five reasons which most closely describe your company's reasons for using long-term leasing as a method of financing the acquisition of fixed assets.
(Indicate your first choice by "1")
(Indicate your second choice by "2")

   (a) income tax advantages not available with ownership [ ]

   (b) requires less capital outlay initially than other forms of financing (i.e., less down payment) [ ]

   (c) avoids the restrictions frequently found in loan agreements [ ]

   (d) does not appear as a liability on the lessee's balance sheet [ ]

   (e) permits hedging of risks, primarily that of rapid obsolescence of asset [ ]

   (f) other, please specify [ ]

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   ___

2. Do you consider the use of long-term leasing, (i.e. more than three years), as expanding your company's total available credit, or what may be called your company's "pool of credit"?

   YES [ ]   NO [ ]

3. Does your company's long-term debt include clauses in the indenture which specifically preclude or restrict the amount of leasing of assets by the company by long-term leases?

   YES [ ]   NO [ ]

   If yes, would you please describe the restrictions on leasing very briefly and, if applicable, describe the assets subject to specific lease restrictions.

   ___

   ___

   ___

4. Do any of your company's long-term leases include clauses in the contract which specifically preclude or restrict the amount of new, long-term debt incurred by the company?

YES [ ] NO [ ]

If yes, would you please describe restrictions on long-term debt very briefly.

____

____

____

5. When your company considers entering into long-term lease arrangements, how much consideration is given to the interest charge expected to be earned by the lessor?

Please mark <u>one</u> only.

(a) considerable [ ]

(b) weighed in an overall appraisal as an important factor [ ]

(c) very little [ ]

(d) none at all [ ]

6. How would you rank the interest rate implicit in long-term leases' with other comparable financing schemes, e.g., bonds, indentures, etc.

Please mark one.

HIGHER [ ] ABOUT THE SAME [ ] LOWER [ ]

Please explain the reason(s) for your opinion briefly.

____

____

____

____

____

7. Do you consider long-term leases which are essentially purchase arrangements, e.g., sale and leasebacks, to be any different in mature from other long-term, noncancellable leases?

YES ☐ SOMETIMES, DEPENDING ON CIRCUMSTANCES ☐ NO ☐

Please give a brief reason for your choice.

____

____

____

8. In deciding between a purchase or lease proposal, does your company use any formal analytical technique such as present value calculations, to determine the real economic consequences of either opportunity?

YES ☐ NO ☐

(a) If yes, describe the technique(s) briefly.

____

____

____

____

(b) If no, describe briefly the basis for the purchase-lease decision.

____

____

____

____

____

9. What disadvantages does your company believe exist in the use of long-term leases?

   Please list those that are applicable in your company.

   ____

   ____

   ____

10. Are you in favor of the formal capitalization of the discounted annual lease payments and the inclusion of this amount among the assets and liabilities on the balance sheet as a standard method of lease disclosure?

    YES [ ] SOMETIMES, DEPENDING ON CIRCUMSTANCES [ ] NO [ ]

    Please explain briefly the reason(s) for your answer.

    ____

    ____

    ____

11. Which of the following suggested answers would give the closest estimate of your opinion of the future role of lease financing in Canada? Please mark one.

    (a) It should continue to strengthen and become a more important financing tool [ ]

    (b) Its future use should not increase much over its present use [ ]

    (c) It should decrease in use and become less significant as a financing tool [ ]

    (d) Other opinions which you may have - describe

    ____

    ____

    ____

    ____

12. Does your company foresee any change in its own policy towards leasing fixed assets?

    Please comment briefly.

    ____

    ____

    ____

    ____

TABLE VII

RESPONSES TO QUESTIONNAIRES

	Analyst	Company
Total number of questionnaires mailed	91	88
Number returned undelivered or not completed	17	12
	74	76
Number received but not useable	3	3
	71	73
Number completed and useable	23	30
Total completed as a percentage of total sent out minus number undelivered and not useable	32%	41%

TABLE VIII

COMPANY - QUESTION 1

Ranking of Reasons for the use of Long-Term Leases by Companies

Reasons	Number of Companies Ranking First	Number of Companies Ranking Second	Mode
(a) Income tax advantages not available with ownership	2	6	
(b) Requires less capital outlay initially than other forms of financing (i.e. less down payment)	21	7	1
(c) Avoids the restrictions frequently found in loan agreements	0	1	
(d) Does not appear as a liability on the lessee's balance sheet	1	3	
(e) Permits hedging of risks, primarily that of rapid obsolescence of asset	3	7	2

TABLE IX

COMPANY - QUESTIONS 2, 3, 4

Results of Several Descriptive Questions - Companies

Questions	Number: Yes	Number: No	Majority as a percentage of total
Question 2. Do you consider the use of long-term leasing (i.e., more than 3 yrs.) as expanding your company's total available credit?	22	8	74%
Question 3. Does your company's long-term debt include clauses in the indenture which specifically preclude or restrict the amount of leasing of assets by the company by long-term leases?	3	27	90%
Question 4. Do any of your company's long-term leases include clauses in the contract which specifically preclude or restrict the amount of new, long-term debt incurred by the company?	1	29	97%

TABLE X

COMPANY - QUESTION 5

Considerations Given to the Interest Rate Charged on Long-Term Leases

Extent of consideration given to interest charges by companies	Number of Responses	Percent of Total
(a) considerable	13	44
(b) weighed in an overall appraisal as an important factor	16	53
(c) very little	1	3
(d) none at all	0	
Total	30	100

TABLE XI

COMPANY - QUESTION 6

Comparison of Lease Interest Rate with Other Long-Term Debt

	Number of Responses	Percent
1. Ranking		
(a) Higher	23	77
(b) About the same	6	20
(c) Lower	1	3
Total	30	100

2. Reasons suggested to explain the higher interest rate

(a) Since a lease can contain a default provision the rate should be higher.

(b) Leasing must be more expensive if lessor is making a profit.

(c) Leasing is considered to be"fringe credit", and thus is more expensive.

(d) Lessor experiences a greater risk in a lease investment than in an ordinary debt form because of bankruptcy implications.

(e) Some finance companies who provide leasing direct their services to those companies of a somewhat higher risk and thus the interest charged is higher in general

TABLE XII

COMPANY-QUESTION 7 and ANALYST-QUESTION 13

Sale and Leasebacks compared to other Long-Term Leases

1. Do you consider sale and leasebacks to be any different in nature from other long-term, noncancellable leases?	Analysts		Companies	
	Number	Percent	Number	Percent
(a) Yes	9	45	17	65
(b) Sometimes, depending on circumstances	-	-	1	3
(c) No	11	55	8	32
Total	20	100	26	100

2. Reasons why sale and leasebacks differ from other long-term leases	Number of mentions - both analysts and companies
(a) Conventional lease does not provide for the same purchase options at maturity, thus residuals may be important	17
(b) Conventional lease does not involve "buying, building and selling" by lessee	2
(c) Closer to secured borrowing than conventional lease	2
(d) Sale and leaseback is a more deliberate attempt to arrange off-balance sheet financing	1
Total	22[(a)]

(a) Number of mentions does not agree with total number of responses, since some respondents did not give an explanation.

TABLE XIII

COMPANY - QUESTION 8

Lease - Purchase Considerations by Companies

1. Does your company use any formal analytical technique to determine the real economic consequences of either opportunity?	Number of Responses	Percent
(a) Yes	16	53
(b) No	14	47
Total	30	100

2. Types of analytical techniques normally use by companies.	Number of Responses
(a) Present value calculations, or discounted cash flows	15
(b) Determination of interest rate in lease	4
(c) Effects on long-run solvency of firm of annual lease payments as a fixed charge	2
Total	21

3. The basis of decision if no analytical techniques used.	Number of Responses
(a) Effects of lease payments and lease arrangement on working capital	3
(b) Leasing must provide some specific advantage not otherwise available	2
(c) Availability of financing at reasonable rates	2
(d) Nature of asset needed	1
(d) Necessity - only means to obtain the asset	1
Total	9

TABLE XIV

COMPANY - QUESTION 9

Disadvantages Reported in Long-Term Leases

Disadvantages	Companies Number	Companies Percent
1. Flexibility is lost in leasing	7	33
2. Leases have a higher interest rate than other forms of long-term finance	8	38
3. Ease of lease negotiation can distort the decision between lease or borrow	2	9
4. Loss of capital appreciation in fixed asset	3	14
5. Loss of residual value	1	6
Total	21	100

TABLE XV

COMPANY - QUESTION 10 ANALYST - QUESTION 10

Formal Capitalization of Long-Term Leases for Disclosure

1. Are you in favor of capitalization as a standard method of long-term lease disclosure	Yes	Some-times	No.	Total
(a) Number of Analysts replying	8	3	11	22
(b) Number of Companies replying	7	7	16	30
Total	15	10	27	52
Percent of total replying to the question	29%	19%	52%	

2. Reasons provided for replies	Number of Mentions
Reasons in favor of capitalization	
(a) better comparisons are possible between companies	6
(b) more consistent method	2
(c) the legal argument of title is important, but disclosure is more important	1
(d) should be capitalized if an equity is created in the asset	1
(e) more attention directed to the respective asset and liability amounts and less estimation of capitalized amounts	2
(f) leasing is a form of debt and should be disclosed as such	4
Reasons against capitalization	
(a) footnote disclosure is adequate	14
(b) capitalization involves many subjective decisions	7
(c) the lessee does not own the assets ("a lease is a lease")	1
(d) the important advantage of off-balance sheet disclosure is lost	1
(e) assets and liabilities of the entity would be overstated	1
Reasons for some possibility	
(a) when the lease is in substance a purchase of the asset	6

TABLE XVI

COMPANY - QUESTION 11, 12

Future Role of Lease Financing in Canada

1. Which of the following suggested answers would give the closest estimate of your opinion of the future role of lease financing in Canada?	Number of Selections	Percent
(a) It should continue to strengthen and become a more important financing tool	22	76
(b) Its future use should not increase much over its present use	6	21
(c) It should decrease in use and become less significant as a financing tool	1	3
Total	29	100
	Yes	No
2. Does your Company foresee any change in its own policy towards leasing fixed assets?	6	20

TABLE XVII

ANALYST - QUESTION 1

Comparison of Long-Term Leases with other Capital Sources

1. Do you consider long-term leases to be a new source of corporate capital and thus serving to expand the company's available credit pool?	Number Yes	Number No	Result
Analysts replying	18	5	Yes

2. Ranking of long-term leases with other conventional sources in terms of decreasing certainty of return on investment and recovery of principal	Number of Mentions	Percent of Total	Cumulative Percent
(a) more secure than mortgage debt	2	9	9
(b) about the same as secured mortgage debt	4	17	26
(c) after secured mortgage debt but before unsecured debentures	9	39	65
(d) about the same as unsecured debentures	2	9	74
(e) after unsecured debentures but before subordinated debentures	1	4	78
(f) about the same as subordinated debentures	2	9	87
(g) after subordinated debentures but before preferred stock	2	9	96
(h) about the same as preferred stock	1	4	100
(i) about the same as common stock	-		

TABLE XVIII

ANALYST - QUESTION 2

Reasons Provided to Support Ranking of Long-Term Leases with Other Capital Sources

Reasons	Number of Mentions	Percent
(a) the nature of the property leased determines much of the security	7	39
(b) the inclusions of penalty payments in the lease	2	11
(c) the lessee's credit is important; if a company can lease it can mortgage	3	16
(d) the security with a lease is less than a direct mortgage charge	1	6
(e) leasing should be after mortgage debt since the debt usually has a floating charge whereas leases do not	1	6
(f) in bankruptcy a lease is a less secure form of debt	3	16
(g) lease wording may provide an escape from the obligation, which is less likely to occur in other debt forms	1	6
Total	18	100

TABLE XIX

ANALYST - QUESTION 3

The Important Factors Which Determine the Investment Security in a Lease

Factors	Number of Rankings as: 1	2	3	4	5	Overall Ranking
(a) the nature and value of the property leased	5	13	3	1	1	2
(b) the renewal options sought by the lessee	-	1	3	8	11	5
(c) the credit of the lessee	16	2	2	-	-	1
(d) the term of the lease and the implicit return on investment	2	4	13	4	-	3
(e) other provisions of the lease, such as cancellation, maintenance and insurance, etc.	-	1	4	8	10	4

TABLE XX

ANALYST - QUESTION 4

Reasons Explaining a Higher Lease Interest Rate As Compared To A Debenture Issue

Reasons Suggested	Number of Analyst Mentions	Percent
(a) The lessor has a greater risk of loss, or less security of investment in the lease	10	56
(b) The lessor must incur greater administrative and financial costs which are associated with leasing	4	22
(c) No logical reason for higher lease rate, except skillful negotiation of terms	4	22
Total	18	100

TABLE XXI

ANALYST - QUESTION 5

Selection Of Possible Rates To Capitalize Lease Payments

Rates suggested	Number of Mentions	Percent
(a) the current Bank of Canada interest rate	-	-
(b) the company's cost of capital if roughly known	5	22
(c) the rate of the specific lease agreement	11	48
(d) an arbitrary rate (e.g. 12 times annual rent payment)	4	17
(e) other	3	13
Total	23	100

TABLE XXII

ANALYST - QUESTION 6

Selection Of The Portion Of Annual Rentals To Capitalize

Possible Selections	Number of Mentions	Percent
(a) total payments made by the lessee to the lessor including lease payments and other service costs for maintenance, etc.	4	17
(b) total lease payments, but not including service costs	15	65
(c) a portion of the lease payments	2	9
(d) other	2	9
Total	23	100

TABLE XXIII

ANALYST - QUESTION 7

The Type of Assets To Capitalize

1. Would your decision to capitalize annual lease payments depend upon the nature of the assets leased?	Number Yes	Number No	Final Result
<u>Analysts Replying</u>	13	8	Yes
2. Would you capitalize the following?			
(a) electronic computing equipment	5	8	No
(b) branch sales office	8	5	Yes
(c) automobiles and trucks	2	11	No
(d) standard machine tools	2	11	No
(e) special production equipment	5	7	No
(f) real estate and buildings	13	0	Yes

TABLE XXIV

ANALYST - QUESTION 8

The Minimum Term Of Leases For Capitalization

1. Would your decision to capitalize lease payments depend upon the length or remaining term of the lease?	Number Yes	Number No	Final Result
Analysts replying	12	5	Yes
2. Consider the following terms:			
(a) 1 year		17	No
(b) 2 years		17	No
(c) 3 - 5 years	6	4	(a)
(d) 6 - 10 years	17		Yes
(e) 10 - 20 years	17		Yes

TABLE XXV

ANALYST - QUESTION 11

Methods of Evaluating Long-Term Lease Commitments

Methods employed by analysts	Number of Mentions (a)	Percent of Total
(a) as a separate factor to be used in reaching a final appraisal of the firm	9	22
(b) as a comparative ratio; expressed for example in relation to sales, assets or total earnings on an industry or inter-company basis	3	7
(c) as a portion of the fixed charges, to be included in interest charges and debt repayment obligations to determine fixed charges and cash flow coverage	15	39
(d) by discounting and capitalizing in some way the value of all lease payments to be made in the future	13	32
Total	40	100

TABLE XXVI

ANALYST - QUESTION 12 (c)

Capitalization Of Lease Commitments And Financial Ratios

1. Do you feel that the financial ratios computed from conventional statements could be any more meaningful by capitalization of long-term leases?	Number Yes	Number No
Analysts replying	12	6

2. Reasons suggested to support the opinion.

<u>Financial ratios are improved</u>:

(a) leases are a form of corporate capital
(b) better measure of the rate of return on corporate assets
(c) inter-company comparisons improved with capitalization

<u>Financial ratios are not improved</u>:

(a) capitalization may cause misleading financial statements
(b) ratios are not the prime interest; mostly concerned with leverage action of lease financing

TABLE XXVII

ANALYST - QUESTION 14

Methods Of Improving Long-Term Lease Disclosure

Improvements suggested by analysts		Number of Mentions	Percent
(a)	More information should be provided as required by the accounting Bulletin No. 20, including: length of term, annual payments, renewals, etc.	16	67
(b)	The lease commitments should be capitalized and shown in the footnotes	3	13
(c)	Those leases which are with a subsidiary or related corporation should be shown separately	1	4
(d)	The annual effect of the lease charge on income, if not specifically stated else-where	2	8
(e)	The interest rate implicit in the lease	1	4
(f)	A statement to explain the nature of a long-term lease, and the possible implications on ratios or fixed charges	1	4
	Total	24	100